United States Court of Appeals

for the Second Circuit

EXHIBITS

76-6109

BANK FAILURES

REGULATORY REFORM

FINANCIAL PRIVACY

B

HEARINGS

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS SUPERVISION, REGULATION AND INSURANCE

OF THE

COMMITTEE ON BANKING, CURRENCY AND HOUSING HOUSE OF REPRESENTATIVES

NINETY-FOURTH CONGRESS

FIRST SESSION

ON

H.R. 8024

A BILL TO EXTEND THE AUTHORITY FOR THE FLEXIBLE REGULATION OF INTEREST RATES ON DEPOSITS AND SHARE ACCOUNTS IN DEPOSITORY INSTITUTIONS, TO IMPOSE A MORATORIUM ON THE USAGE BY FINANCIAL INSTITUTIONS OF ELECTRONIC METHODS OF FUNDS TRANSFERS, AND TO IMPROVE PUBLIC UNDERSTANDING OF THE ROLE OF DEPOSITORY INSTITUTIONS IN HOME FINANCING

UNITED STATES COURT OF APPEALS
FILED
OCT 29 1976
A. DANIEL FUSARO, CLERK
SECOND CIRCUIT

PART 2

JULY 16, 17, AND 21, 1975

Printed for the use of the
Committee on Banking, Currency and Housing

Exh. Vol. I

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PART 2

JULY 16, 17, AND 21, 1975

Printed for the use of the
Committee on Banking, Currency and Housing

U.S. GOVERNMENT PRINTING OFFICE

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BANK FAILURES

REGULATORY REFORM

FINANCIAL PRIVACY

WEDNESDAY, JULY 16, 1975

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
SUPERVISION, REGULATION AND INSURANCE,
OF THE COMMITTEE ON BANKING, CURRENCY AND HOUSING,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:05 a.m., in room 2128, Rayburn House Office Building, Hon. Fernand J. St Germain [chairman of the subcommittee] presiding.

Present: Representatives St Germain, Moorhead, Boggs, Rousselot, Johnson, Wylie, and Brown.

Mr. ST GERMAIN. The subcommittee will come to order.

This morning the subcommittee welcomes Gov. Robert C. Holland, Board of Governors, Federal Reserve System. Governor Holland last appeared before the subcommittee on December 12 in connection with our hearings on the failure of the U.S. National Bank of San Diego.

At this point, I wish to place into the record a copy of the subcommittee's invitation of June 30 addressed to Chairman Arthur Burns, and the Board's response of July 7, copies of which have been furnished to each subcommittee member.

Without objection, so ordered.

[Testimony resumes on p. 706.]

[The correspondence referred to by Chairman St Germain follows:]

FERNAND J. ST GERMAIN, R.I., CHAIRMAN
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JAMES M. HANLEY, N.Y.
WILLIAM S. MOORHEAD, PA.
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BUTLER DERRICK, S.C.
THOMAS L. ASHLEY, OHIO
WALTER E. FAUNTROY, D.C.
LINDY (MRS. HALE) BOGGS, LA.

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U.S. HOUSE OF REPRESENTATIVES

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
SUPERVISION, REGULATION AND INSURANCE
OF THE
COMMITTEE ON BANKING, CURRENCY
AND HOUSING

NINETY-FOURTH CONGRESS

WASHINGTON, D.C. 20515

June 30, 1975

Honorable Arthur F. Burns
Chairman
Board of Governors of the
Federal Reserve System
Washington, D. C. 20551

Dear Mr. Chairman:

As per our recent discussion with Governor Holland and the continuing discussions between our respective staff members, I request your appearance before the subcommittee on July 16, 1975 at 10:00 a.m. in Room 2128, Rayburn House Office Building. At this time the subcommittee will receive your proposals for bank regulatory reform. In light of the long-term notice you have received we expect to be presented with the Board's position on this matter. In addition, we would appreciate hearing your views on bank structural reform since they will be of assistance in our continuing deliberation in connection with the FINE Study. We anticipate the need for a full day to allow for adequate consideration of your views on these important areas.

As you know, on June 18, 1975, I introduced H.R. 8024, a copy of which is attached. On June 26, the Subcommittee on Financial Institutions commenced hearings on this bill, and I am enclosing a copy of my opening statement delivered on that day. Inasmuch as each of the regulatory agencies will be appearing before us on bank reform matters from July 15 through July 21, we will accept a written statement on the Board's views on this bill in lieu of a personal appearance. We do not plan to mark-up H.R. 8024 until the conclusion of our bank regulatory hearings.

During the hearings on July 16 we will first concentrate on the developments which resulted in the Franklin National Bank being placed into receivership and those events which occurred subsequent to that process. The subcommittee

my recommendation to the subcommittee that this bill be considered as an integral part of the FINE Study.

Finally, we are also interested in the Board's position on H.R. 2752, introduced by Mr. Stark, and subsequently reintroduced with thirty-six cosponsors and H.R. 1005, introduced by Mr. Rousselot, our ranking minority member, copies of which are attached. Mr. Reuss requested a report from the Board on H.R. 550 introduced by Mr. Koch, a copy of which is attached, on February 10, 1975, and I have been informed by the full committee that their records indicate that no reply has been received from the Board. In view of the subcommittee's interest in the issue of bank secrecy, we would also appreciate the Board's position on H.R. 550 at this time. In addition, we would like to afford you the opportunity to revise your previously expressed views in this area. This subject is extremely important since it involves the constitutionally guaranteed right to privacy. It is important to receive the bank regulatory agencies' views on this legislation, because of their familiarity with the internal procedures used in this area and the effect such legislation will have on the roles of the regulatory agencies themselves. In light of the recent court decisions handed down by both the Supreme Court of the State of California (Burrows v. Superior Court) and the U. S. Supreme Court (U. S., et al., v. Bisceglia and CBA v. Shultz), the subcommittee recognizes the need for action in this area. It is our hope to proceed with the mark-up on a bill dealing with this matter upon the return of Congress from the August recess.

In accordance with the Rules of the Committee, to permit distribution to subcommittee members, please submit 80 copies of your prepared testimony to the subcommittee office, Room B303, Rayburn House Office Building, by noon Monday, July 14.

Sincerely,

Fernand J. St Germain
Chairman

FJStG:lBh

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ROBERT C. HOLLAND
MEMBER OF THE BOARD

July 7, 1975

The Honorable Fernand J. St Germain
Chairman
Subcommittee on Financial Institutions
Supervision, Regulation and Insurance
Committee on Banking, Currency and Housing
House of Representatives
Washington, D. C. 20515

Dear Mr. Chairman:

I am responding to your letter of June 30 to Chairman Burns requesting the testimony of the Board of Governors before your Subcommittee on July 16 on several subjects including bank regulatory reform. As the member of the Board of Governors who has had the major responsibility for developing and analyzing proposals for regulatory reforms, I have been designated by Chairman Burns to represent the Board at the forthcoming hearing.

Since you have asked for positions and comments on a number of separate subjects, I thought it might be useful beforehand if I outlined how I would propose to structure my testimony.

It would be my intention to begin with a discussion of the Federal Reserve's role in the case of Franklin National Bank, including the use of the discount window by Franklin, the Federal Reserve's actions in relation to the Comptroller of the Currency and the Federal Deposit Insurance Corporation, and certain administrative and supervisory actions which the Federal Reserve has undertaken as a result of the Franklin case. I would follow this with a discussion of the "failing bank" bills (H. R. 4008 and H. R. 5331), which you have introduced by request.

My testimony would next turn to a progress report on the Board's study of supervisory and regulatory problem areas. This will include an explanation of legislative proposals which the Board expects to be submitting to the Congress. The final part of my prepared statement would address itself to the issue of banking regulatory agency reform and the present thinking of the Board on this subject.

BEST COPY AVAILABLE

At your request, the Board will be submitting a written report on H. R. 8024 prior to the hearing, and while I will not address myself to this legislation in my statement, I will be prepared to respond if the Subcommittee desires to ask questions about the Board's views on the three titles of the bill. I would propose to follow this same procedure with regard to the several bills relating to bank secrecy and the right to financial privacy. The Board's comments will be submitted to you in advance of the hearing by letter, and I will be ready to discuss the Board's comments.

I hope that the above format is satisfactory and not inconsistent with what you had in mind in your request for testimony. I look forward to meeting with your Subcommittee on the 16th.

Yours sincerely,

Robert C. Holland

CHAIRMAN OF THE BOARD OF GOVERNORS
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

July 14, 1975

The Honorable Fernand J. St Germain
Chairman
Subcommittee on Financial Institutions
Supervision, Regulation and Insurance
Committee on Banking, Currency and Housing
House of Representatives
Washington, D. C. 20515

Dear Mr. Chairman:

Thank you for the opportunity to comment on H. R. 8024, which would (a) extend the authority for flexible regulation of interest rates for an additional year; (b) extend the term of the National Commission on Electronic Fund Transfers; (c) impose a 90-day moratorium on Electronic Fund Transfer Systems (EFTS); and (d) provide for public disclosure by depository institutions of the location of their mortgage loans and savings deposits, and a study of the feasibility of broadening the proposed disclosure requirements.

TITLE I--
REGULATION OF INTEREST RATES

The Board favors the eventual removal of interest rate ceilings, as recommended by the Administration's proposed "Financial Institutions Act of 1975" (H. R. 5291). It is important that rates on time and savings accounts of thrift institutions and commercial banks be more competitive with those on market instruments. Extensive diversion of funds from those accounts into Treasury issues, and more recently into liquid-asset mutual funds, has occurred during periods of high interest rates. Moreover, new ways to avoid interest rate ceilings may continue to be devised, requiring frequent patchwork efforts to prevent substantial diversions of funds from depository institutions.

Immediate and across-the-board removal of interest rate ceilings, however, could disrupt the operations of many thrift institutions and small commercial banks. It is the Board's view that the authority to impose interest rate ceilings should not be removed until thrift institutions and small banks have had an opportunity to diversify

their portfolios to the point that they can compete effectively for deposits without such ceilings.

For this reason, the Board supports the one-year extension--through December 31, 1976--of flexible interest rate authority as provided by Title I of H. R. 8024.

TITLE II--
ELECTRONIC FUND TRANSFERS

The Board supports section 201 of H. R. 8024, which would extend the term of the National Commission on Electronic Fund Transfers for "two years after the date of the confirmation by the Senate of the Chairperson."

The Board does not support the thrust of section 202, however, which raises problems insofar as it would authorize the new Commission to control all EFTS experimentation conducted by financial institutions. The Board believes that if any additional controls are found to be necessary, they should be implemented by the financial regulatory agencies rather than by giving quasi-regulatory powers to a temporary Commission with essentially data-gathering, research, and advisory functions.

Title II also would impose a 90-day absolute moratorium on EFTSystems, in contrast with the two-year moratorium under H. R. 1619. The Board's views on the latter bill, which were sent to you on March 10, 1975 (copy enclosed), also are applicable to Title II of H. R. 8024. While recognizing that significant issues are raised by the deployment of EFTS facilities, the Board continues to believe that broad experimentation with such facilities, rather than a moratorium, is desirable in view of the increased and more convenient banking services that they are expected to produce. Moreover, the legislation establishing the National Commission provides clear notice that subsequent actions with regard to expansion of EFTS facilities by any party should be undertaken with the knowledge they may be subject to recommendations made by the Commission and any resulting legislative actions taken by Congress.

Also, a number of definitional provisions of the moratorium proposal are unclear. In particular, the scope and nature of the proposal appear so broad as to raise questions regarding the permissibility of existing non-consumer related funds transfer arrangements, such as automated clearinghouse arrangements among depository institutions and also banking or governmental arrangements regarding transfers of funds sent over existing Federal Reserve wire facilities.

TITLE III--
MORTGAGE DISCLOSURE

The Board supports the objective of helping to make funds more readily available under reasonable standards of creditworthiness to finance the transfer and upgrading of housing and related commercial facilities within the neighborhoods of our metropolitan areas. However, the Board does not believe that Title III, which apparently is based on the premise that local time and savings deposits should be used essentially for local credit, is wise legislation.

It is clearly in the best interests of financial institutions to accommodate the legitimate credit needs of their local communities. Both the institution and the community benefit economically from such a policy. However, it should be recognized that one of the main functions of financial intermediaries is to provide greater mobility for the economy's savings and investments. Financial institutions are the principal conduit for the flow of funds from savers in areas with capital surpluses to areas of capital deficiency. Any restraint on the capacity of financial institutions to invest funds outside their local markets would risk inhibiting the flow of capital that is essential to support vigorous economic growth throughout the nation as a whole. It also would invite the risk that savings may move away from local financial institutions.

In addition to this fundamental difficulty, the Board has a number of reservations about specific provisions of Title III.

First, Title III omits information that is extremely hard to quantify and interrelate but is nonetheless necessary for a fair assessment of a lender's policies. No requirement for information is included, or proposed for study, with regard to the character of the properties financed, the financial status of borrowers, or the nature or intensity of demands for credit in the local areas--all factors that bear on patterns of credit flows within and among localities. While the Board does not urge the collection of these additional details for depository institutions in all metropolitan areas in view of the additional costs that would be involved, it questions whether in the absence of such data the information to be disclosed under Title III would be sufficient to achieve the purpose to which the legislation is addressed.

Second, it is often difficult to distinguish between unfair lending practices and prudent financial management by institutions responsive to the needs of local savers as well as of local borrowers. The reporting mandated under Title III may give misleading impressions of unfair discrimination--impressions that might promote the adoption of lending practices that could seriously disadvantage local depositors.

The Board believes that a more promising approach to the complex problem of upgrading declining neighborhoods would be to enlist the cooperation of local governments, property owners, residents, and financial institutions--all acting together toward this common objective in given areas. One experiment along these lines, which has already demonstrated its usefulness in a limited number of neighborhoods, is the Urban Reinvestment Task Force. Originally a joint endeavor of the Federal Home Loan Bank Board and the Department of Housing and Urban Development, the Task Force will be joined shortly by representatives from the Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation.

If the Congress should nevertheless decide that specific data collection is helpful in determining the existence and extent of "redlining," the Board believes that the appropriate course for the Congress to take would be to authorize a pilot study of credit flows in relation to community needs. Such a pilot study should be based on a sampling of financial institutions within, say, no more than five to ten standard metropolitan statistical areas (SMSAs). Congress should prescribe the general objectives of the study, and the agency performing the study should consult with the financial supervisory agencies in the design of the study. Provisions for carrying out the study should be adopted by each agency for the institutions supervised by that agency. In this regard, the agencies should be given broad discretion in determining the specific information to be obtained and the survey methods and procedures to be utilized. The results of such a study would better enable the Congress to evaluate the need for the compilation of information in all SMSAs, as prescribed by H. R. 8024.

As a specific technical problem, the bill would require disclosure of one item that seems impractical to obtain even on a sampling basis. Section 304(a)(1)(A) and (C) would require each

depository institution to disclose the number and total dollar amount of the real estate loans "made by that institution which were outstanding as of the close of the last fiscal year of that institution." Such a disclosure requirement could not be met fully by any institution originating loans that it subsequently sold, because these loans, once sold, might be removed from its records.

We hope these comments will be useful to your Subcommittee in the further consideration of H. R. 8024.

Sincerely yours,

Arthur F. Burns

Enclosure

The Honorable Fernand J. St Germain
Chairman
Subcommittee on Financial Institutions
Supervision, Regulation and Insurance
Committee on Banking, Currency and
Housing
House of Representatives
Washington, D. C. 20515

Dear Mr. Chairman:

Thank you for the opportunity to comment on H.R. 1619, a bill to impose a moratorium on the offsite deployment by financial institutions of automated teller machines and related funds transfer devices.

The Board believes that the deployment of offsite facilities, whether automatic teller machines or POS terminals, offers the potential for significant benefits to the public in the form of increased and more convenient services. It is recognized, however, that certain legal and policy issues are raised by such deployment.

The Board believes the establishment of offsite automated teller machines at places of employment, retail establishments, or at other locations convenient to a bank's customers should be permitted on a trial basis wherever States have not expressly prohibited their usage by statutory or regulatory action. Such devices might even be established across State lines. These machines involve no other parties than the bank and its depositors and provide an extension of banking services to existing customers.

It may be useful to require some periodic reporting of offsite facilities and their usage. In providing such information, however, some Federal standard might be adopted to protect the privacy of the individual.

POS systems involve the legal and policy issues which, in part, gave rise to the creation of the National Commission on Electronic Fund Transfers. The Commission will examine the potential benefits of this new technology and, if determined necessary, propose legislation regarding its employment.

With respect to POS systems, some experimentation appears to be desirable during the Commission's existence and, hence, the Board would not object to legislation that would permit experimentation to continue but, at the same time, would limit the potential for expansion of a permanent nature. Institutions involved in the deployment of such systems during the Commission's existence might not be "grandfathered" so that Congress could require action taken by financial institutions to be modified at a later date.

We hope these suggestions are helpful. We would be pleased to make our staff available to provide any further assistance that may be required.

Sincerely yours,

(Signed) Arthur F. Burns

Arthur F. Burns

CHAIRMAN OF THE BOARD OF GOVERNORS
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

July 15, 1975

The Honorable Henry S. Reuss
Chairman, Committee on Banking,
Currency and Housing
United States House of Representatives
Washington, D. C. 20515

Dear Mr. Chairman:

I am pleased to respond to your request for the views of the Board of Governors concerning H.R. 7483, the "Right to Financial Privacy Act of 1975," and H.R. 550, a bill "To protect the constitutional rights of citizens of the United States and to prevent unwarranted invasions of privacy by prescribing procedures and standards governing the disclosure of information to government agencies." This letter also furnishes our comments on H.R. 1005, also entitled the "Right to Financial Privacy Act of 1975," and covers H.R. 2752, which is identical to H.R. 7483.

The Board endorses enactment of legislation which will protect the constitutional rights of United States citizens and prevent unwarranted invasions of personal privacy by prohibiting disclosure of financial records except under prescribed strict procedures and standards.

Under the provisions of these several bills, a customer's financial records in a financial institution could not be disclosed to a governmental agency (or, to "any person" in the case of H.R. 550) without either the approval of the customer, the issuance of a subpoena or summons, or a court order. (H.R. 550 would limit disclosure to customer consent and court order.) The bills therefore affect most directly the law enforcement activities of the Departments of Justice and the Treasury. They do not appear to be intended to limit the Federal or State bank regulatory agencies in carrying out their responsibilities. We are, however, suggesting several clarifications in order to insure that this apparent intent is acnieved.

First, the bills would exempt from coverage the dissemination of any financial information which is not identified with, or identifiable as being derived from, the financial records of a particular customer. It is believed that this provision would permit the continued collection of most economic and financial data needed by the bank regulatory agencies, but the phrase "identifiable as being derived from" (section 11(a) of H.R. 7483, H.R. 2752, and H.R. 1005) could be misinterpreted in a manner that would interfere with the collection of data associated with individual customer accounts. The Board suggests the phrase be deleted from those bills and that following the end of the sentence (section 11(a)), there be inserted some such clause as the following:

> Nothing in this Act shall be construed to prevent the collection of statistical data under procedures that insure protection of the confidentiality of individual reports.

Such added language would acknowledge the need to preserve the data collection authority presently contained in such acts as the Federal Reserve Act (38 Stat. 251, as amended), and the Bank Holding Company Act (70 Stat. 133).

Another problem perceived by the Board relates to the definition of "customer" in section 3(d) of H.R. 7483 and H.R. 2752, and in section 3(4) of H.R. 1005 which states:

> The term 'customer' means any person patronizing a financial institution and utilizing services offered by that financial institution.

Such a broad definition of "customer" could be interpreted to mean, for example, that if a bank holding company borrowed from its subsidiary bank, then the holding company would become the subsidiary's "customer." If so, the override provision of two of these bills (section 18 of H.R. 7483 and H.R. 2752) would appear to prevent the Board from requiring any information on such a transaction, "...except solely in the exercise of (the Board's) supervisory function..." (section 11(b)), regardless of other responsibilities placed on the Board by existing legislation. The Board therefore urges that Congress remedy this problem by inserting the following underlined words in section 11(b) of H.R. 7483, H.R. 2752, and H.R. 1005:

except in the exercise of (the Board's) supervisory, monetary or regulatory functions....

The above suggested language would also expressly take into account the Board's unique monetary functions and responsibilities.

Another problem could arise from strict application of the prohibited access provision of section 4 (section 3 of H.R. 550). Both the Federal Reserve and the Treasury have an interest in analyzing U.S. investments of oil-producing countries; for example, we need to know the amount of official investments by particular countries in the United States. The purpose is not to release such information to the public (which is never done) but to serve as a basis for informed policy decisions and for possible negotiations with particular countries. It is not clear that the proposed legislation would permit United States agencies to obtain such information except in accordance with the provisions of section 4 (section 3 of H.R. 550).

For supervisory purposes, the Board might also want to be able to ascertain the amount of loans made by a U.S. bank to a particular foreign bank, apart from a regular bank examination. It is not clear whether the Federal Reserve Board could obtain that information directly from the U.S. bank (under section 11(b) of H.R. 7483, H.R. 2752, and H.R. 1005). Likewise, it is unclear whether the Board could obtain such information from the Comptroller if the lending U.S. bank were a national bank.

Some related problems are posed by these legislative proposals. Section 10 of the aforementioned three bills prohibits the transfer of certain information from one Government department or agency to another "except where the transfer of such information is specifically authorized by statute." Under current law, the Board is authorized to furnish financial information "to the State authorities having supervision of such banks, to officers, directors, or receivers of such banks, and to any other proper persons." (12 U.S.C. 326) In addition to the persons specified by statute, the Board has found it desirable to exchange examination reports with the Comptroller of the Currency and the Federal Deposit Insurance Corporation. Moreover, in connection with enforcement of criminal or civil provisions of the banking laws and regulations, it is desirable from time to time to make available information involving customer records to the Department of Justice or the Securities and Exchange Commission for

investigative purposes. To deal with these matters, we suggest the addition of a sentence at the end of section 11(b) to read as follows:

> "Nothing in this title prohibits any supervisory agency from exchanging examination reports or other information with another supervisory agency, or from supplying information to a prosecuting or enforcing agency concerning a possible violation of a regulation or statute administered by the supervisory agency."

We note also that these bills would permit financial (fiduciary) institutions to disclose records, under the customer consent provision, for differing periods of time: one year (H.R. 7483 and H.R. 2752), three months (H.R. 1005) and one week (H.R. 550). The one-year authorization seems preferable to us as a matter of administrative efficiency.

The provisions of H.R. 550 differ from those of the other three bills, but the foregoing comments apply generally to its provisions as well. However, H.R. 550, alone, prohibits disclosure of a customer's financial records to "any person." We believe this broader, stronger, prohibition is preferable to the limited prohibitions contained in the other bills against disclosing those records to government agencies, and we suggest that the Congress extend the prohibition to "any person" in all these bills.

Another provision of H.R. 550, not contained in the other bills, would permit the Secretary of the Treasury to require fiduciary (financial) institutions to maintain financial records relating solely to customers' international transactions, as that term is defined by the bill (section 6(2) of H.R. 550). We believe that such a provision would be helpful, perhaps essential, to the Secretary in executing his statutory duties. We urge that the Congress consider incorporating such a provision into any final version of a financial privacy bill.

Also, we note that the prohibitions of H.R. 1005 are limited to Federal agencies and personnel. Presumably under the bill's terms, a financial institution could disclose a customer's financial records without constraint to state or local agencies.

The Board appreciates the opportunity to comment on this pending legislation, and, we hope that our comments will be helpful to you and the other members of the Committee.

Sincerely yours,

Arthur F. Burns

Mr. ST GERMAIN. Due to the scope of the hearings, by agreement with Governor Holland, we will proceed to question Governor Holland, first on the position taken by the Board on the provisions of H.R. 8024, as set forth in the Board's response of July 14, a copy of which is before each member. We will then proceed to consider the Board's position on a number of privacy bills, including H.R. 1005, introduced by the subcommittee's ranking minority member, Congressman Rousselot. Governor Holland will then be asked to proceed with his formal statement submitted in response to our letter of June 30, with questioning to take place at the conclusion of the Governor's remarks dealing with the failure of Franklin National Bank, ending on page 14; again at the conclusion of remarks on H.R. 4008, the so-called Failing Bank Bill, ending on page 32. Finally, we will turn to a consideration of the Board's bank regulatory reform proposals, taken up by the remainder of Governor Holland's remarks.

At this point I wish to insert into the record a joint press release of Chairman Reuss and myself, dated April 24, previously furnished each member of the full committee, announcing the current study of the Nation's financial institutions and their regulation by the Federal Government.

Without objection, so ordered.

[The joint press release referred to follows:]

NEWS RELEASE

HOUSE BANKING COMMITTEE WILL LAUNCH MAJOR REVIEW OF NATION'S FINANCIAL INSTITUTIONS

House Banking, Currency and Housing Committee Chairman Henry S. Reuss (D-Wis.) and Representative Fernand J. St Germain (D-R.I.), Chairman of the Subcommittee on Financial Institutions Supervision, Regulation and Insurance announced today that the Committee will undertake a major review of the nation's financial institutions and their regulation by the federal government. The project will be known as the Financial Institutions and the Nation's Economy (FINE) study, and is expected to lead to legislative action.

The chairmen said the FINE study will encompass five areas: the relationship between banks and thrift institutions, and what changes may be desirable in their borrowing, lending, investment, and customer service activities; the adequacy of federal regulation, as now divided among three government agencies for banks alone; the structure and operations of the Federal Reserve System; the operation of U.S. banks abroad, of foreign banks in the U.S., and of the Eurodollar market; and the operation of bank holding companies.

The chairmen said:

> The American banking system is fundamentally sound. Our financial institutions provide the greatest pool of private credit in the world. But the demands on our financial system have expanded enormously in recent years. The rapid growth of foreign banking, unprecedented expansion into new areas such as real estate trusts, and technological changes such as electronic banking, have seriously challenged the ability of the industry to manage the nation's financial resources effectively.
>
> Homebuyers, small businesses, and state and local governments have periodically been squeezed out of the market, causing hardship for millions of Americans.
>
> Proposals for reform of the system have come from the Administration and from leaders in the financial world. There is a compelling need to consider these proposals as a part of a comprehensive review of how the institutions function in today's economy and how well they serve the needs of all Americans.
>
> Several commissions have studied these issues in recent years. Among them have been the "President's Commission on Financial Structure and

Regulation" (Hunt Commission), December 1971; the Commission on Money and Credit, 1961; The Heller Report of 1963; and the Comptroller's Report of 1962. While much that is valuable has emerged from these studies, they have been limited by the lack of substantial participation by consumer and citizen groups, as well as from the Congress. There will be no need to repeat their work. But the review now contemplated will be a wide-ranging, comprehensive study of the financial system.

The review will be conducted by the Financial Institutions Subcommittee, with Chairman St Germain presiding. All members of the Banking Committee will be invited to take full part in the proceedings, with the same rights as subcommittee members to request witnesses, ask questions, and help frame the issues. Our goal is that legislation be produced for completion in the 94th Congress.

The Members of the Banking Committee are: Henry S. Reuss, Chairman; Wright Patman, William A. Barrett, Leonor K. (Mr. John B.) Sullivan, Thomas L. Ashley, William S. Moorhead, Robert G. Stephens, Jr., Fernand J. St Germain, Henry B. Gonzalez, Joseph G. Minish, Frank Annunzio, Thomas M. Rees, James M. Hanley, Parren J. Mitchell, Walter E. Fauntroy, Lindy (Mrs. Hale) Boggs, Stephen L. Neal, Jerry M. Patterson, James J. Blanchard, Harold E. Ford, Carroll Hubbard, Jr., John J. LaFalce, Gladys Noon Spellman, Les AuCoin, Paul E. Tsongas, Butler Derrick, Philip H. Hayes, Mark W. Hannaford, David W. Evans, Albert W. Johnson, J. William Stanton, Garry Brown, Chalmers P. Wylie, John H. Rousselot, Stewart B. McKinney, John B. Conlan, George V. Hansen, Richard T. Schulze, Willis D. Gradison, Jr., Henry J. Hyde, Richard Kelly, Charles E. Grassley, Millicent Fenwick.

BACKGROUND MEMO O. "FINANCIAL INSTITUTIONS AND THE NATION'S ECONOMY STUDY"

Subjects to be considered in the study include:

RELATIONSHIP BETWEEN BANKS AND THRIFT INSTITUTIONS

The nation's financial system, and the institutions which comprise it, is archaic and jerry-built. The study will examine these institutions in the light of the needs of the people who deal with them and the needs of today's economy.

Questions will include whether increased competition among institutions would meet these needs. Should thrift institutions be allowed to offer more complete banking services? Since funds for mortgages are periodically drained out of the thrift institutions as savers seek higher interest rates elsewhere, what changes would alleviate these cycles? Are special incentives, such as favorable tax treatment or other methods of allocation, needed to assure adequate funds for housing? Would elimination of restrictions on savings rates and the prohibition against paying interest rates on checking accounts be beneficial? How can more equitable treatment of the consumer as a saver or borrower be achieved?

REGULATION OF BANKS

Over the years a patchwork structure of bank regulation has grown up to the point where three different agencies (Federal Reserve Board, Federal Deposit Insurance Corporation, and the Comptroller of the Currency) are involved in bank supervision. In addition the Federal Home Loan Bank Board oversees the thrift institutions. The situation is further confused by acts regulating bank holding companies which give the Federal Reserve exclusive jurisdiction over multi-bank and one-bank holding companies. The conflicting and overlapping pattern of regulation results in what critics have called "competition in laxity among regulators."

The case of the Franklin National Bank, which was saved from collapse only by $1.7 billion in loans from the Federal Reserve, and the experience of 1974 when a number of banks found themselves overextended in a number of ways, have raised serious questions about the adequacy of bank regulation. The Committee will consider possible ways of restructuring and perhaps unifying bank regulation.

STRUCTURE AND OPERATIONS OF THE FEDERAL RESERVE SYSTEM

A number of questions have been raised in regard to the Federal Reserve System. They include the terms of board members and whether the Chairman's term of office should coincide with that of the President of the United States. Questions have also been raised as to the membership of the Open Market Committee, which determines the rate of growth of the money supply, and whether the decisions of the committee should be kept secret. Basic question of whether the monetary authority should also be responsible for bank regulation must also be considered.

FOREIGN BANKING

The explosion of international banking has been the most dramatic development of the past decade. In the last five years there has been a threefold increase in the assets of foreign branches of U.S. banks. Twenty percent of the entire assets of the U.S. banking system are held abroad, for the most part unregulated and not subject to reserve requirements and other safeguards that apply to domestic assets. At the same time there has been a seven-fold increase in the assets held in the U.S. by foreign banks. These operations raise similar questions of regulation and supervision. Concern has been expressed as to balance of payments problems, foreign exchange speculation, competitive advantages and the undermining of restrictions in U.S. laws separating banking and commerce.

OPERATION OF BANK HOLDING COMPANIES

In the last few years there has been an extraordinary increase in the number of bank holding companies, and in their acquisition of banks and bank-related operations. Questions have been raised about potential domination by banks of certain non-banking activities such as factoring and leasing, and about precisely what activities are appropriate for banks. Other problems involve possible risks to the banks themselves from rapid expansion into non-banking activities. The Committee will consider whether any steps are needed to safeguard competition within the industry or with other businesses, and whether capital and management are adequate for the kind of risks undertaken.

Mr. ST GERMAIN. The review, known as the FINE study, is being conducted by this subcommittee, with the participation by all full committee members. Thus, as we continue to meet on current legislative and oversight responsibilities, we are now commencing the arduous task of gathering essential facts necessary for the development of a comprehensive bank regulatory reform bill.

During our deliberations on H.R. 8024, we continued our examination of relationships between banks and thrift institutions, regulation Q, focusing on segments of our population not now being served by our financial institutions for a variety of complex reasons, redlining, and through title II, the EFTS moratorium, began the process of considering the impact of technological development on substantive banking laws and regulations.

Before proceeding with questions concerning the Board's position on H.R. 8024, I wish to clarify several aspects of title II, the 90-day moratorium, in the same manner as I did yesterday, which caused the Federal Home Loan Bank Board to modify its written position. Title II simply gives the Commission time to get itself organized, review what has taken place to date insofar as experimentation is concerned, study the procedures utilized by the regulatory agencies, and to advise the respective committees of jurisdiction at the end of a 90-day period of its plans for the continuing review and evaluation of ongoing experiments in furtherance of the commission's mandated objectives.

Title II in no way affects the continuation or implementation of EFT systems which have already been approved, as in the case of

the Federal Home Loan Bank Board or those for which notice has been given to the Office of the Comptroller.

My purpose in introducing moratorium legislation, identical to Senator Proxmire's bills in the 93d and 94th Congresses, was to underscore the importance of the National Commission in a continuing effort to persuade the President to activate the Commission by submission of the name of a Chairman and Executive Director for confirmation and appointment of the public members. I need not review my extended correspondence with the President, and remarks to my colleagues on the floor, deploring inaction, but simply state that the 9-month delay has been most regrettable, and apparently the statutory members since the date of enactment of Public Law 93–495 on October 28, 1974, have felt that they could not confer with each other while awaiting Presidential action to evolve a common position and procedure on the experimental question. It does appear now, however, that the President will have nominated the Chairman and Executive Director by the time the subcommittee marks up H.R. 8024, immediately after the August recess.

Finally, and most importantly, the use of the word control in the bill was not intended to indicate that the Commission would take over from the regulatory agencies the authority to approve EFTS experiments or to second-guess such approvals. At the end of 90 days, the Commission will merely advise the committee of its plans for the evaluation of such experiments insuring full and adequate consideration of the public policy questions inherent throughout.

Each regulatory agency, during the 2 years this subcommittee has been looking into EFTS questions, on more than one occasion has expressed its support for the Commission. We hope and expect that each agency will furnish evidence of their support by working together within the Commission framework to insure public understanding and acceptance of EFTS developments.

Governor Holland, with respect to H.R. 8024, the bill we clarified yesterday—and I believe there were representatives of Fed here monitoring the hearings, and I attempted again to clarify this morning—it appears to me that when you look at the composition of the Commission, we are dealing with a great many members, statutory members, who have been intimately involved with the electronic systems. Certainly, the Fed has. You gave birth to it. The legislation in no way intends to interfere with any ongoing systems, and that includes the automatic clearinghouses, et cetera.

Now, with this clarification, I would ask if you are in a position to give us a little rethinking with respect to your analysis and the Fed's reaction to title II.

Mr. HOLLAND. Yes, I would be glad to, Mr. Chairman. I can give this only provisionally, because I was running through it in the light of yesterday's discussion.

In general, as you well know, we have favored the Electronic Funds Transfer Commission and share some of the same frustration that you have in how long it is taking to get going, and look forward very keenly to cooperating with it and to benefit from its results. We are impressed by the task that the Commission faces in getting itself organized and prepared to attack these problems. Even though, as

you well point out, there will be some knowledgeable people on that Commission, it will be an organization that will take a bit of time to get moving. The tasks that they face are very difficult ones.

It is hard to predict how long it will take for them to get a clear grasp of where the main problem areas are and what might be the recommended solutions. Therefore, we may feel somewhat conditioned by what has happened since the EFTS bill was passed. But it does make us believe that moratoriums are not a desirable interjection into the unfolding payments process while this is going on.

Mr. ST GERMAIN. May I interrupt you at that point?

Mr. HOLLAND. Yes.

Mr. ST GERMAIN. I will agree that a moratorium in many instances is an unusual step. We really do not want to take it. However, it is obvious when one looks at what has been done by the regulatory agencies involved, principally and primarily the Comptroller's Office and the Home Loan Bank Board's procedures, that colloquy is called for, indeed colloquy that could be joined not only by the Home Loan Bank Board and the Comptroller's Office but by the Fed and other statutory members of the Commission, and a couple of people from State agencies, because there are problems that have arisen within the States with EFTS.

This 90 days, frankly, would provide an opportunity for the people involved to sit down, to get together and take the best out of that which has been done by reviewing the experimentation to date.

As Mr. Perry, from the Home Loan Bank Board stated yesterday, 90 days is not an inordinate period of time. Ninety days does not discourage people who have been consulting with different firms to determine what the comparative costs of systems are. I am talking about the bank or the S. & L. that might want to develop a system—they can continue these discussions, no one is saying to them, you cannot, at the end of that 90 days, submit your application. An application, in reality, I would imagine, takes more than 90 days to prepare, if it is a well-done application. I would like to consider it in that light.

As I say, we are not trying to suspend everything. We realize that EFTS is a thing of the future. By the same token, I think things have been running along rapidly here. Every now and then, it is advisable to pause and reflect and analyze——

Mr. HOLLAND. I certainly agree with you, dialog, colloquy, and reflection on this issue are called for, among all the parties you are talking about. The thing that bothers us is the interdiction of thousands—perhaps it is millions—of private decisions that move along, each at various stages, involving our payments mechanism. We think a law that says stop those new decisions for 90 days is an interruption of some consequence.

Mr. ST GERMAIN. Which decisions are you referring to?

Mr. HOLLAND. The decisions by the private parties who are trying to decide whether or not to add a new item of equipment, or to engage in another kind of process.

Mr. ST GERMAIN. Certainly, this does not stop them from making decisions. They can make their decisions, knowing that their request will be acted upon and can even be in the process of review during the

90-day period. It is just that the final approval or disapproval would not come until the 90-day period has elapsed. So you are not precluding—you are not saying to everybody, stop thinking.

Mr. HOLLAND. I appreciate that, Mr. Chairman. You are telling them that there is another fixed time frame that they have to adjust to and take account of. They cannot do anything until that period is over.

It seems to me that there is less trouble with a moratorium for 90 days than for 6 months, for 6 months than for a year. It is an interruption in the flow of the development of new and changing processes. This is an area that is changing quickly, there is a lot of experimentation. It seems to me, it is better to let it go forward, with everybody knowing the Congress is taking a look at it and may change it.

I would not be so inclined to take this position, Mr. Chairman, if Congress itself had not made it very clear that all actions going forward in the payments mechanism process are subject to modification in the light of the legislation based on the Commission's recommendations. The conference report on that made a very clear statement to us. We have that engraved in our minds, as we proceed day by day, week by week. I think participants in the marketplace have it in mind, as well. In effect, as I say, Congress has given them warning that something is coming, which they have to adjust to. And it seems to me that is a fair basis on which to proceed.

Mr. ST GERMAIN. How long does it take to draft an application for a new system? Do you have any familiarity with that?

Mr. HOLLAND. It depends on the elaborateness of the arrangement, Mr. Chairman. For—let us say, a branch application. I would say it takes less time than such things as deciding on the area in which you want to open, do your market surveys, finding the land, getting commitments for the land, and so forth. I believe the application itself would only take a moderate amount of time. It may take several weeks. I would not think it would take any more time than that.

Mr. ST GERMAIN. Many witnesses who are against the moratorium, and proponents of EFTS, cite the fact that there is a great consumer demand for Electronic Funds Transfer Systems, or CBCT. Do you subscribe to this statement that there is great consumer demand for these services?

Mr. HOLLAND. I think it is more the fact that there is a lot of consumer convenience involved in what is being offered. As consumers become aware of that added convenience, they respond affirmatively to it. I have seen some surveys that show that when you ask the average man or woman on the street, would you like to be able to do something electronically, they, as often as not, are negative to it. Things are going fine as they see it, right now. But when they get the chance to get electronic service, there has tended to be, in place after place around the country quite a response in terms of increased customer interest.

I think that that is the proof of the marketplace, that it is a helpful thing to the average family.

Mr. ST GERMAIN. Do you recall the period of time in which credit cards were flowing around—like a snowstorm in Alaska or Minnesota?

Mr. HOLLAND. I do.

Mr. ST GERMAIN. We had hearings here, and the trade associations came up and said, oh, it is a great thing. And personally, every time I opened my mail, I had another credit card from another financial institution. It boiled down to the fact that everybody had set up credit card systems. Eventually they all pulled in their reins, and we are now back down to a limited number of credit cards, are we not?

Mr. HOLLAND. That is right, Mr. Chairman. I think as a part of that process, the competition, while it produces excesses and some exotic episodes——

Mr. ST GERMAIN. And losses.

Mr. HOLLAND. And losses, for the most part, right on the backs of the financial institutions that took a flier in it. The competition that tried to produce the kind of card and the kind of conditions that served the customer best really sharpened the provisions that are associated now with our typical credit card. Of course, you legislated, and we put some regulations in the field, as it developed. I would say now that people would say that the credit card is a major convenience for the average American family. I think you are right to hark back to former issues, look for analogies as to what might develop in the electronic payments field. The only difference is, that the issues may even be bigger.

Mr. ST GERMAIN. How many different systems do we have at the present? Someone, last night, about 6 o'clock in our hearings, stated that there are 31 different types of systems presently set up. Would that be an accurate number?

Mr. HOLLAND. I would like to check the record and come back to you with an official figure. There are several big ones and a number of regional ones, and more specialized——

Mr. ST GERMAIN. An off-the-cuff position—does that seem unreasonable?

Mr. HOLLAND. I do not think there are that many.

Mr. ST GERMAIN. There could be 29 or 32.

Mr. HOLLAND. That sounds a little large to me, in terms of large nationwide general purpose credit systems. I imagine that there are that many of a regional nature and national nature for regional use. I am excepting, of course, the specialized credit cards, the gas cards, and similar operations.

[Governor Holland subsequently submitted the following information for the record:]

There are two large nation-wide credit card systems used by financial institutions. The cards associated with these systems are the Master Charge and BankAmericard. In addition, there are about a half dozen credit card systems that are reportedly being used by a number of financial institutions, including Riggs Central Charge which is familiar locally.

Mr. ST GERMAIN. Getting back to my question about consumer demand—in your opinion, basically, the benefit of EFTS accrues to whom? Does it accrue to the consumer, or does the greater benefit accrue to the financial institutions involved?

Mr. HOLLAND. If you look beyond the transition to the time the systems are well in place, I would say benefits are going to be shared by and large by two groups, the depositors or the savers in the institutions, and the borrowers from the institutions.

Mr. ST GERMAIN. What benefit accrues to the saver and borrower, or will accrue?

Mr. HOLLAND. A mature EFTS system ought to significantly cut the per item cost of handling payments, which is rising, and it looks like as long as we stay with the paper system, the financial institution that figures out how to cut the price in the first instance will get more profit. If he tries it and makes a mistake, like some did in the credit card business, he will incur a loss.

Mr. ST GERMAIN. What happens to that profit?

Mr. HOLLAND. I think what will happen is that, in the first instance, one financial institution will figure out how to do it effectively. Another one will imitate him. A third will enter the field. The pressure of competition will disperse the major part of the profit in two ways, either lower charges to the borrowers or higher payments to the savers, the depositors who leave money with them.

Mr. ST GERMAIN. Is the Federal Reserve Board, which is a very dominant force on the coordinating committee, at this time prepared to state that, as the systems are perfected, they will approve an increase in the interest rate to be paid to depositors so they can enjoy the benefits, the profits that come from this operation?

Mr. HOLLAND. I cannot speak for the whole Board. I can tell you how I feel about it, Mr. Chairman.

I believe that we would be best advised to have the interest rate ceilings, under our regulations, at as high a level as the financial institutions can afford to pay. I think we need to pay savers more these days. This country needs more savings now and in the years ahead.

I think that cutting the cost of the payments mechanism through electronic transfer systems would increase the ability of financial institutions to pay higher interest rates to savers. That is one of the things that I certainly would take into account in going to the higher rate. I expect to see the benefits of automation shared with the customers of the institutions.

Mr. ST GERMAIN. At this time, I would ask you to discuss this question with the other members of the Board. And now I am going to ask my staff to make sure we address this question to the other members of the coordinating committee, to determine whether it is their intent to see to it that a fair portion of the profit that will accrue as a result of reduced personnel will be passed on to the saver, to the depositor.

Mr. HOLLAND. I can guess what kind of letter you will get back.

Mr. ST GERMAIN. I am going to get a lot of horse feathers, I know. I will get about 55 if's. But, you know, you sit up here and you keep listening to statements that allege that there is going to be a benefit to the consumer. The poor consumer out there has been waiting around for a long, long time to see benefits from these improved operations, from these amendments that we go along with on behalf of financial institutions. I for one feel that the time has come for those of us who sit up here and vote on the floor of the House to start supporting measures and going along with measures and changes and improvements when they are going to be such that an actual, tangible benefit will accrue to the consumer.

Mr. HOLLAND. I will take it back to my colleagues, and will put the question to them.

Mr. ST GERMAIN. To reduce the number of if's, and take a stand.

Mr. HOLLAND. We will have to consider the circumstances in each case. I am pretty sure myself, Mr. Chairman, we will say to you that electronic transfer systems and competition in their development are bound to drive that down over time.

Mr. ST GERMAIN. Drive what down?

Mr. HOLLAND. Drive the gains from the reduced cost of the electronic funds transfer out in the form of higher payments to savers and/or lower charges to borrowers.

Mr. ST GERMAIN. Does the Fed have any data or statistics that could tell us, the committee, particularly the subcommittee, about the funds study? How many banks in this country are paying regulation Q rates? In other words, the rate that is allowable and approved by the coordinating committee as against the financial institutions that are paying one-half, one-quarter or one-half points under regulation Q?

Mr. HOLLAND. Yes, we have a rate survey that periodically samples the banks and gets the results.

Mr. ST GERMAIN. By Federal Reserve Board regions or what?

Mr. HOLLAND. Yes, it is by Federal Reserve Board regions.

Mr. ST GERMAIN. Do you know when the latest survey was conducted?

Mr. HOLLAND. I think the latest one was done in February. There should be another one due along shortly. It is complicated information—bulky information that takes awhile to process.

Mr. ST GERMAIN. Since it is bulky and takes awhile to process, will that information tell us, in the Boston Home Loan Bank Board region, that x number of banks in Vermont, New Hampshire, and Connecticut are paying the maximum under regulation Q, x number of banks are paying a half point under, and x number of banks are paying one point under?

Mr. HOLLAND. It should be able to show some of the components. The main series I am thinking of is structured as a sample. I believe we can give you results of that sample. It is a good sample. Would you like me to put that kind of information in the record?

Mr. ST GERMAIN. We are very interested in that, Governor Holland.

Mr. HOLLAND. I would be glad to put it in the record.

[The information is contained in the Fed's response to the subcommittee dated September 8, 1975, and may be found in appendix A.]

Mr. ST GERMAIN. On H.R. 8024, title I, I note the Board does support the 1-year extension.

Mr. HOLLAND. Yes; we do.

Mr. ST GERMAIN. Oh, yes, in your letter of July 14, the second paragraph, financial institutions are the principal conduit for the flow of funds from savers in areas with capital surpluses to areas of capital deficiencies. Do you have your July 14 letter before you? We have copies here, if it would be helpful.

Mr. HOLLAND. Yes, sir.

Mr. ST GERMAIN. Particularly when we look at the nature of thrift institutions and the mandates by the Congress to the thrift institutions, the S. & L.'s, when they were established in 1933, and when we look at the goodies that have been accorded the thrift institutions by the Congress over the years, rightfully so, as an assist to these thrift

institutions so they could perform their primary function, which is to provide mortgage money, and financing to the average middle-income wage earner. The mandate, as I recall it is to encourage savings and provide mortgage credit for people in the area who wish to purchase homes—right?

Mr. HOLLAND. Yes.

Mr. ST GERMAIN. It is something to talk about; this flow of capital from capital surplus areas to areas where there is a shortage of capital. No one can disagree with that. However, by the same token, when you are determining whether or not you have a surplus is there not some type of obligation to first take care of the area in which you are operating and from whence you derive this capital, in other words, the deposits?

Mr. HOLLAND. I think the major obligation that arises of that type is the obligation of good business in relation with the people from whom you are drawing your funds.

Mr. ST GERMAIN. Right. I hope the Fed has had people monitoring these hearings. We have made it very clear that title III does not contemplate that the Prudent Man Rule would not be exercised, that the financial institutions would not look at the value of the home as against the price of the home, that it will certainly continue to look at the credit rating of the potential borrower. We in no way intend to interfere with that.

Mr. HOLLAND. If I may speak plainly on the point, Mr. Chairman, I think that it comes down to this. We share your distaste and the committee's distaste for any kind of discrimination in the allocation of credit against particular areas of the city, or for that matter, particular borrowers. They are not credit worthiness distinctions. The problem is identifying how can you practically develop a scheme that can identify those occasions and, in effect, punish the wrongdoer.

Mr. ST GERMAIN. No one is trying to punish the wrongdoer. Maybe we better explain title III to you.

Mr. HOLLAND. I understand——

Mr. ST GERMAIN. It is merely information gathering. In your statement, you refer to the nature and intensity of demands for credit in the local areas. Frankly, I for one doubt we can come up with an effective mechanism that would tell us exactly what the demand is, because in many instances, people will just not go to a financial institution for a loan because they have heard that that particular institution is not lending in a particular area of the community. And so that sort of removes, or cuts down on the effectiveness of trying to monitor or measure what the demand is.

Mr. HOLLAND. I agree, Mr. Chairman. I have talked to borrowers who have said that to me when I asked them how they were managing to get credit on an inner city home. But the simple information about where loans are made in a city is not adequate to judge whether or not there is a redlining or discriminatory practice.

Mr. ST GERMAIN. Does the Fed, and do you, have any problem with the premise of title III that disinvestment does in fact occur and is being practiced by certain financial institutions in certain inner city areas?

Mr. HOLLAND. We cannot prove it. We have had many comments made to us about it. I know this committee and other committees of the Congress have had many comments made to them about it. So I believe that where there is smoke, there is fire, and that there is a problem. However, I believe collecting the kind of information H.R. 8024 calls for is not going to help us solve that problem. I think that is a nonsolution.

Mr. ST GERMAIN. By us, whom do you mean?

Mr. HOLLAND. Whoever the Congress in its wisdom asks to collect that information. I am trying to look at this in terms of the objectives you are after and the results that would be achieved. It seems to me that H.R. 8024 is going to produce a lot of information, a lot of paper that still will not suffice to make the judgment as to whether or not there is a redlining practice.

We struggled, as I believe you know, through a private study, along with some of the other Federal agencies, to try to see if information collection of this or some related type could help us make that judgment. We spent a lot of money investigating it.

Mr. ST GERMAIN. On the basis of race?

Mr. HOLLAND. Yes. We found we did not have enough information to reach a conclusion. As we thought about the additional information we would need to arrive at a conclusion, it seemed very expensive. Indeed, it seemed to us increasingly, while this was an important area, the social values are important enough to try to do something, to keep trying to experiment, to keep trying to explore, that this particular way of gathering information was not going to crack the problem.

Mr. ST GERMAIN. Is there any data available today from any source about this problem?

Mr. HOLLAND. We did these pilot studies——

Mr. ST GERMAIN. On discrimination as far as race is concerned.

Mr. HOLLAND. Yes.

Mr. ST GERMAIN. We are not talking about race.

Mr. HOLLAND. We did look at ZIP code areas——

Mr. ST GERMAIN. Because of race?

Mr. HOLLAND. Yes. It was a strongly race-oriented investigation. That is right.

Mr. ST GERMAIN. Do you have any data whatsoever right now, from any source, from any place in the country, nationally, that would give you any information on lending patterns of financial institutions?

Mr. HOLLAND. As a matter of fact, we do, Mr. Chairman. We have shared your desire to try to see how much of a problem exists, and the frustration in trying to gather factual proof. Therefore, about a year ago, instead of just trying to get facts to see whether something is happening, we decided to talk directly to the managements of the institutions that would be making these decisions.

We asked our examiners, every time they went in to examine a bank, to sit down and ask the management of the bank about their lending practices, whether or not they rule out any geographic areas in making loans, whether they have any geographic areas where they only make a few loans, and if so, why. We call their attention to title VIII, which says they should not have any discrimination. If the examiner gets answers that are not consistent with what he has been

finding in the note case of the institution, he rechecks, and in some of those cases, we believe that this examiner inquiry helped to shift management attitude toward a better kind of access for funds.

We do not claim this is a revolution, but it is one practical step forward that we found we could do, and we have been doing for a year. We believe that kind of examiner inquiry is nudging bank managements, warning them to be even more careful.

Mr. ST GERMAIN. Who knows about this? Has this been provided to HUD, or to anyone else?

Mr. HOLLAND. I imagine the HUD people know we have been doing this.

Mr. ST GERMAIN. Has this information been given to HUD?

Mr. HOLLAND. This has been a part of our examination process, and that we hold confidential.

Mr. ST GERMAIN. HUD cannot get that type of information?

Mr. HOLLAND. No; we are not allowed to give it.

Mr. ST GERMAIN. It is confidential?

Mr. HOLLAND. Right. We can, however, tell them what we are finding in general terms.

Mr. ST GERMAIN. Can you give it to HUD by cities, census tracts, or ZIP code areas?

Mr. HOLLAND. We could probably work on something like that. I think the essence, however, of this approach, Mr. Chairman—the reason why this may be helpful, and I believe it is—is because of the relationship that exists between the examiner of a bank and the management of that bank.

The examiner is not an independent, outside information collector; he is that management's supervisor. When that management's supervisor starts asking him, are you following this practice, we believe that generates a kind of extra insurance, extra pressure on the management to be careful to stay within the spirit of this legislation.

Mr. ST GERMAIN. Title VIII relates to discrimination on the basis of race, does it not?

Mr. HOLLAND. Race, color, religion, or national origin.

Mr. ST GERMAIN. It does not refer or have any reference whatsoever to disinvested areas?

Mr. HOLLAND. No, but one of the specific questions we have asked, are there any neighborhoods, or other areas of high concentration of minority group members in which the bank refuses to make real estate loans?

Mr. ST GERMAIN. You just said high concentration of minority group members. That is not a disinvested area?

Mr. HOLLAND. No. This is trying to find if there are areas in which the bank does not make loans.

Mr. ST GERMAIN. You are talking about minority group areas, not disinvested areas.

Mr. HOLLAND. No, we did not ask questions on savings and how the savings related to loans——

Mr. ST GERMAIN. On lending.

Mr. HOLLAND. This is on lending. We are asking—are there areas in which you are refusing to make real estate loans?

Mr. ST GERMAIN. You say areas of concentration.

Mr. HOLLAND. Any areas or neighborhoods that have high concentration of minority group members.

Mr. ST GERMAIN. You have a lot of disinvested areas that do not have a heavy concentration of minority groups.

Mr. HOLLAND. That is true, Mr. Chairman.

As you say that, now that I think about it, I think we should consider expanding this survey to try to get at other pockets of disinvestment.

Mr. ST GERMAIN. Title VIII does not require them to invest in disinvested area, but title VIII does require them not to discriminate against minority groups.

Therefore, though you have that question in there the bank can answer the question but still keep going on as they have been going on all along, right?

Mr. HOLLAND. That is right. In terms of the language of title VIII.

Mr. ST GERMAIN. I want to turn the questioning over to Mr. Moorhead, but here is what title III is all about, Governor Holland.

A lot of financial institutions compete because the interest rate is the same that they are paying within a market area. Oddly enough, a lot of them, you know, will pay one point, a half a point less. They are all doing the same.

Competition is there. They compete on who is giving away a television. Competition in prizes.

We would like to consider this information as a prize too. In other words, you let the people of the community know that x out of 10 institutions, there are 3, 5, 9 who are reinvesting in the community. And then the people could determine, whether or not, on their own, they should put their savings in the institutions that invest out of the area, or do they want to encourage and deposit in those institutions that invest in the area.

There is no question, no intent on the part of the sponsors of this legislation to state that this is step No. 1 that is going to the something else. We just feel the cloak of secrecy that is around financial institutions, should be pierced to some degree.

We feel, some of us feel, at least, that it would not be detrimental to us, to let the people know where they are investing their funds.

Mr. HOLLAND. I think one drawback that I have not mentioned thus far, Mr. Chairman, is that I believe the numbers that are asked for in H.R. 8024 will not give a reliable representation to the customers in the community of what is going on.

Mr. ST GERMAIN. What do they have right now?

Mr. HOLLAND. Nothing.

Mr. ST GERMAIN. Capital N-o-t-h-i-n-g, nothing. This would be something, would it not?

Mr. HOLLAND. Yes, it would.

Mr. ST GERMAIN. I have always felt that something is better than nothing. Correct?

Mr. HOLLAND. Well, I think it depends on what you want to attack. This I would regard as an expensive costly something.

Mr. ST GERMAIN. What is the cost, Governor Holland.

Mr. HOLLAND. Getting this information, particularly by census tracts has a fairly sizable cost-burden on the individual institutions.

Mr. ST GERMAIN. Have you been told of the testimony of the Bureau of Census, Dr. Sternlieb and Dr. Greenwood of Minnesota on ZIP codes?

Mr. HOLLAND. ZIP codes are much easier than classifying this information by census tract.

Mr. ST GERMAIN. Did your efficient personnel that were here yesterday tell you what would be the cost by census tract, according to the Census Bureau?

Mr. HOLLAND. No.

Mr. ST GERMAIN. They are going to give us a report. We anticipate that it will be beneath $1 per mortgage. Under a dollar. Dr. Sternlieb, who is with the Census Bureau, as an advisor, said he would like to establish a firm to charge $1 a mortgage. And it would be a very profitable deal indeed.

Mr. HOLLAND. I do not think that $1 would be such a small figure, considering the number of mortgages in these institutions.

Mr. ST GERMAIN. We will get back to that, but I would like to yield to my colleague.

Mr. MOORHEAD. Mr. Chairman, I think I would be happy to have the questionnaire made a part of the record. Mr. Chairman, the questionnaire that Governor Holland has should be made a part of the record.

Mr. HOLLAND. I would be glad to do it. I want to say to both of you, I do not regard this questionnaire as the solution to the problem.

I regard this as a step in the right direction—a practical action to push on the point of discrimination.

Mr. ST GERMAIN. On the legislation that mandated this?

Mr. HOLLAND. The legislation said that discrimination was illegal. The questionnaire was our way of pressing the organization, checking to be sure they were complying with the law.

Mr. ST GERMAIN. Is that your responsibility?

Mr. HOLLAND. Yes, it is. I intend to go back and think, about whether we cannot recognize as well as your interest in other areas of disinvestment, or redlined areas, other than minority areas. You have asked a question that is in my view a matter of fair public policy, even if it is not a statutory requirement.

[The information is contained in the Fed's response to the subcommittee dated September 8, 1975, and may be found in appendix A.]

Mr. MOORHEAD. The other thing, Mr. Chairman, I wonder if Governor Holland can supply. We are not trying to invade the privacy of individual bank investigation. But some aggregate in some form that will show us the results of your questionnaire.

Mr. HOLLAND. I think I ought to be able to do something like that, Congressman. They are scattered all over the country because we do attack this on an individual basis. It is not the kind of information that we ordinarily pull together in aggregate.

If you will give us a little time to think how we might do it, I should be able to produce something that will give you a sense of the findings as a basis in which to obtain your advice as to further use of the questionnaire.

Mr. MOORHEAD. I really think it would help. Knowing your questionnaire and the results, maybe, we can suggest things that would broaden it along the lines that the chairman has suggested.

I know that in my area, the biggest area of complaint, has nothing to do with racial issues. The people think that they are not being treated fairly by the principle financial institutions of the neighborhood.

I am interested in your thought about a pilot study. And I would take it from your letter, the letter of July 14, that you are thinking of this as all financial institutions, that it would include, for example, insurance companies.

Am I correct in that assumption?

Mr. HOLLAND. Well, the experiments that we have done thus far have included just depository institutions; banks, S. & L.'s, mutual savings banks, credit unions. But insurance companies have been, at times, important mortgage lenders.

I think that the more important thing, the really difficult problem here is figuring out what kind of information it is practical to get that will help to eliminate the problem, rather than expand the types of institutions that you get it from.

Once we find a reasonable, practical package of information that illuminates the issue, I believe that we will find we can ask for that information from a number of different organizations. That kind of questionnaire can readily be made applicable to different kinds of lending institutions.

I think there is something to be said in staying with the depository institutions at the start, because if we are to be involved in this in cooperation with other financial agencies and HUD, those are the ones we know best. They are the ones from whom we might have the best chance of producing helpful findings.

We should extend the range to all financial institutions if the results are to be used for an expression of public policy.

Mr. MOORHEAD. Do I understand, you, the Fed, were conducting this kind of inquiry with savings and loans, savings bank?

Mr. HOLLAND. We had a cooperative arrangement among the agencies, the organization of the data, the processing of it, and so on.

We used several different ways of collecting the information in order to experiment with alternatives. They all turned out results that were a long ways short of perfect.

We got information from all types of depository institutions. That information was all consolidated and analyzed in order to give a picture of the lending in that city by all depository institutions.

Mr. MOORHEAD. In the letter, you point out that there is no requirement for the nature or intensity of demand for credit. I can see, if we covered all sales from the start, we would certainly reduce the size of the problem of trying to delve into the nature and intensity of demand for credit. Could we do it, if we chose to go your pilot study route, could we make a real attempt to find out the nature or intensity of demand for credit?

Mr. HOLLAND. I would personally recommend that we try to do so, that it would be better to make the pilot study so small that it is only one city, or one neighborhood. And then, make it intense enough, so that you try to reach the demand question, as well as the supply question. Then try to keep track of what it cost, how much you inconvenience people, as well as institutions, because you are probably going

to have to knock on doors and talk to the individuals as well as talk to the management of the lending institutions. It will take that kind of an intense look at the sample area in order to try to get an insight into whether there is some way of exploring this issue that is going to be practical and informative.

Mr. MOORHEAD. I am convinced that there are some neighborhoods, particularly where there is a larger proportion of middle age people who have paid off their mortgage, which will look bad if one merely examines demand.

Mr. HOLLAND. You sound like a researcher, Congressman. That is exactly what is going to happen, some of the results we have found, some of the cities we have looked at, have suggested just that. Savings have a life profile for the average family, you borrow when you are younger, are net savers when you are older.

If you have an area that is middle age or over, it is likely to be an area of saving surplus. It suits those people as well as the community for the surplus to be going somewhere else. It should be no reflection on them or their financial institution that serves them if there are not any mortgages made in that area.

Mr. MOORHEAD. But there are other neighborhoods I know of that really do have demand, yet they see the neighborhood savings and loan lending a heavy proportion of their funds in the suburbs while the residents of the neighborhood, who are the depositors can't get mortgage money.

Mr. HOLLAND. I would like to say, Congressman, I will sound, now, like an economist or a banker, I do think it is important for us to always be aiming to get credit extended to the creditworthy. I am not talking about a subsidy or lending money to places or individuals where the repayment pattern is bad. It should be on a businesslike basis. But making an allowance for those business considerations, I think we need to try to find a way to see that those deserving credit are accommodated.

Let me tell you a story about our questionnaire. In some of our banks the answer to the question, are there neighborhoods in which you refuse to make real estate loans, was a flat yes, there are neighborhoods where we refuse to make loans. The examiner was instructed to go back and talk to the bank. That is just exactly what the bank should not be doing.

And the examiner went back and found out the reasons for the answer. He found that the area was one where you could not get insurance on the property. It is not good credit business to lend on an uninsured property.

Mr. MOORHEAD. Do not think we did not address that question earlier where we had redlining.

Let me ask one more question, Mr. Chairman.

In the very kind of neighborhoods that we are trying to save, the houses traditionally are less expensive, they are $10,000 or even less, when a prospective purchaser or an owner wants rehabilitation, he does not want a big amount of money. He will want, maybe, a $5,000 mortgage. He is turned down, because they say we cannot afford, if you come back to us for $20,000, we can handle it. He does not want $20,000, all he wants is just enough to buy that house.

I understand it is not discrimination. This is not a racial problem. It is just the economics of the situation if the financial institution does not think it can make money on a small loan. These are the very people we want to help preserve and keep homeownership in these neighborhoods, that may, if we do not have money, go downhill.

I would just say, if you would ponder that when you get the transcript, if you could give me your answer to that almost unanswerable question.

[The information is contained in the Fed's response to the subcommittee dated September 8, 1975, and may be found in appendix A.]

Mr. HOLLAND. I do think that it is one of the most difficult, and at the same time, one of the ones that seems most promising, if we could turn it around.

I agree that very often those are the kind of loans that do the most dollar for dollar in picking up a community that is doing a slide.

We have been most impressed, as perhaps you can judge from our letter, with some of the signs we have gotten that the urban reinvestment task force represents a way to get together a lot of the parties interested in an area, and jointly try to figure out what can be done to make the whole climate of the area better so that it would be more credit worthy, generate more jobs, be a nicer place to live, have more police protection, less crime, less vandalism. Then insurance comes back and credit comes back. That is one of those rare occasions, it seems to me, where there is such a plan, where the whole is greater than the sum of its parts. If you can get that kind of a joint effort working, you can lower the cost of almost all of the ingredients.

Mr. MOORHEAD. Thank you Governor, thank you, Mr. Chairman.

Mr. ST GERMAIN. Mr. Wylie.

Mr. WYLIE. Thank you, Mr. Chairman, Governor.

I have no objection to collecting the data that is required under these bills if there is no invasion of privacy. To say that some information is better than nothing, I do not think it is always necessarily true. The information may be harmful and misleading, or it may be costly to gather.

It was mentioned that there would be a cost of approximately or someone said he could do the reporting as required by this bill for $1 for each mortgage.

How much would be added to report each deposit? Under this bill, we are also required, or someone would be required to report each deposit.

Yesterday, Mr. Matz was here from Philadelphia. He said that they run far more money into planning neighborhoods now than comes into the institutions. Or far more than goes out in the form of a loan, that comes in the form of deposits. That is why I say I think it would probably be all right to collect the data and let the people in the community know whether they want to invest in the particular financial institution, even though it may be making loans in a suburban area.

I think ultimately you put your finger on it. The financial institution is not in the business of losing money. The ultimate test of each borrower must somehow be his credit worthiness, it seems to me.

I wanted to get to the statement that you prepared, the lengthy statement.

Mr. ST GERMAIN. We are dividing this hearing and the questioning of Governor Holland, because there is so much involved.

Mr. WYLIE. This may be related, I notice on page 12 you say, that you have a program of making a list of so-called problem banks. And Jim Smith mentioned that last fall when he was here, the fact that there are approximately 150 banks on that list.

One of the banks that failed, of course, was Franklin National, and another was U.S. National. Did bad loans or bad risk have anything to do with their failures?

Mr. HOLLAND. Oh, yes, in both cases. There was much more than that involved in Franklin, much more than that involved in U.S. National, nonetheless, bad loans, loans that were not adequately supported with value that would generate repayment, either by collateral or income, as a whole, were very much a problem for both of those organizations.

Mr. WYLIE. We do not like to get into a position of pressing a financial institution into a situation, where they would almost be required to make bad loans or risk loans. Even in a declining area where we——

Mr. HOLLAND. One has to worry about that. A bank does live and die by confidence. It is the only organization we have that has promised virtually to pay back all of the money on demand, or short notice. That means it has to be able to keep the confidence of the people. The FDIC insurance helps a lot. Still there is quite a bit of money that comes into the institutions these days that is outside insurance coverage. You need to have the confidence of the owner, in order to keep money. Once confidence starts to go in an institution, it can be very hard to keep it.

I am sorry to tell you, over this past weekend about a $60 million bank—in a city I used to call home—in effect went under, and had to be sold to a new owner, with FDIC assistance, because that bank had put a lot of money into real estate, a good bit of it in the city.

There were a variety of reasons, not only those loans went bad. It could not be pulled back. The confidence began to be lost in the organization and they had to be taken over and replaced with another institution.

It is a risk that one has to keep in mind.

Mr. WYLIE. It is a consideration we have to keep in mind certainly. How many other problem banks are on your list right now?

Mr. HOLLAND. For our banks, the precise number is 56. That is a little higher than it has been in times in the past in the postwar period.

Mr. WYLIE. You mentioned another factor that you refer to in your statement, that is the factor of community psychology and adverse market attitudes and questions about banking and so forth, which I think is related in this bill, related to H.R. 8024. Does the community psychology and market attitude influence people, as far as economic conditions in the community are concerned?

Mr. HOLLAND. Yes; I think so. As a community starts to change, its economic coloration starts to deteriorate, that starts to rub off on all the attitudes about institutions or business in the area and that is an extra handicap that those organizations have to carry.

When an area starts to deteriorate, one after another, various elements of that area start to drain away.

That is why I believe it takes a concerted attack to try to deal with the problem.

Mr. WYLIE. I have been given a note that my time has expired.

Thank you very much. I will have other questions on your testimony.

Thank you, Mr. Chairman.

Mr. ST GERMAIN. Governor Holland, with respect to U.S. National in San Diego and Franklin National and Security of New York, you do not mean to say that those failures were due to loans in disinvested areas or redlined areas, do you?

Mr. WYLIE. He did not say that.

Mr. ST GERMAIN. I did not want to leave that impression in the record. In the case of U.S. National, it was C. Arnholt Smith's self-dealing. Franklin National was playing the float.

Mr. HOLLAND. They were doing a number of things, as you well know.

Mr. ST GERMAIN. Security National invested in areas that were not disinvested areas, principally Long Island; is that not right? There is nothing disinvested about that area.

Mr. HOLLAND. No; I would think that Long Island is probably a saving surplus area on balance.

Mr. ST GERMAIN. It was not a question of disinvestment in those cases. Rather, some pretty poor management.

Mr. WYLIE. If the gentleman would yield.

Mr. ST GERMAIN. I want to ask another question. In your $60 million bank, your home town bank that failed over the weekend, did they lend some money to REIT's or to apartment complexes that did not come back? Or did they fail because they lent in disinvested areas?

Mr. HOLLAND. They had mortgage loans, as I understand the situation, I am not sure about REIT's. I think they had loans to apartments, to a number of commercial real estate operations, to residential properties scattered throughout the city. I think some of those would turn out to be in what you would call a disinvested area. I want, as you, not to have the record be wrong. I would not argue, that was the one thing that brought them down. I think they had gotten loans in other real estate areas, as well as in disinvested areas that contributed to the problem. It did have something to do with that particular case.

Mr. ST GERMAIN. Would it be possible for staff to take a look at those sheets at the earliest possible time?

Mr. HOLLAND. In effect, Mr. Chairman, the bank has changed from one ownership to another. It does not make it any easier to get the information on demand as to where savings come from or where loans go to.

Mr. ST GERMAIN. We are not looking for demand savings accounts. I am interested in determining whether this bank failed because it had an overabundance of loans in a disinvested area. Does your home town have a redlined area, your former home town?

Mr. HOLLAND. I am not sure. The town I am talking about is Chicago. That is not my original home, but I lived there for about 10 years. It is an area I know well.

There has been some evidence before this subcommittee that may lead you to think that, yes, there is redlining in Chicago. I have a study here that points in that direction. What I am trying to say

is that we do not have the information to identify what is a disinvested area.

Mr. ST GERMAIN. We have some pretty good statistics on Chicago, Governor Holland.

Mr. HOLLAND. They did not do that well on the deposit side.

Mr. ST GERMAIN. We are not talking about deposits. We are talking about loans that went sour.

Mr. HOLLAND. Perhaps I misunderstand.

Mr. ST GERMAIN. Mortgages that were not repaid.

Mr. HOLLAND. Perhaps I misunderstand.

Mr. ST GERMAIN. By a disinvested area, I am trying to use a nice term, the other term is a redline area. The circle is drawn around it. The decision is, that, we are not going to accept any mortgages in that area, even though the applicant makes $12,000 to $15,000 a year. He can qualify in every respect, he is credit worthy, et cetera. We are not lending in that area. That is what we mean by a disinvested area.

With that understanding, would you say that a $60 million bank fell because of an overabundance of mortgages in disinvested areas?

Mr. HOLLAND. That would be too strong a statement. I would like to go back and review that more carefully. As a matter of fact, Mr. Wille, who will be testifying next week, the Chairman of FDIC, is in a better position to answer than I.

The FDIC bought the assets of that bank, as a part of doing the weekend rescue operation.

Mr. ST GERMAIN. You mentioned this new questionnaire you have had in effect for a year. Have your examiners determined whether or not from these responses that there have been violations of civil rights as far as redlining in a minority area is concerned?

Mr. HOLLAND. There is no case where they have concluded that they have found a violation of the Civil Rights Act.

Mr. ST GERMAIN. Any other ones?

Mr. HOLLAND. They went back to people that gave answers suggesting possible violations, and pressed them for reasons. They got some reasons. I think the honest statement is we have no findings that we could send to a district attorney, and say prosecute under the law.

What we did accomplish is to exercise an influence on the managements of those banks, that makes it more certain that they will conform to the letter and spirit of title VIII.

Mr. ST GERMAIN. Did your examiners find any cases that were close in the gray area?

Mr. HOLLAND. They found a number of cases where they had to do a lot of checking. In the end, they found no violations.

Mr. ST GERMAIN. The action was the examiners talking to the bank?

Mr. HOLLAND. In cases where the banker says something that the examiner thought did not square with what they found in the records of the bank, they would do some checking.

Mr. ST GERMAIN. Does it go beyond the examiner, or does the examiner handle it?

Mr. HOLLAND. We expect the examiner to handle it.

Let me try to say a bit more about this to explain to you how it works, why we think it may be doing some good.

Mr. ST GERMAIN. Could you do that for the record because I have to give Mr. Moorhead my time.

Mr. HOLLAND. I would be glad to although I am already obliged to supply you the form of the questionnaire and we can accompany that with a discussion of how it operates.

As I say, we do not think this is a cure-all. We do think it is something that is helping.

[The information is contained in the Fed's response to the subcommittee dated September 8, 1975, and may be found in appendix A.]

Mr. MOORHEAD. I understand the Governor has a prepared statement.

Mr. ST GERMAIN. I would like to get a few questions in on privacy.

Governor Holland, under section 10 of the privacy bill, the Board would not be able to furnish financial data to the State authorities that have supervision of such banks, to directors or receivers or any other proper person. Your concern with respect to furnishing data to State regulators and receivers is understandable.

Why do you feel that officers and directors of financial institutions should have access to such data, beyond the ordinary course of bank business?

Mr. HOLLAND. Would you give me a moment, Mr. Chairman, to find the spot we are focusing on?

Mr. ST GERMAIN. I am referring to page 3 of your statement, the middle of the last paragraph.

Mr. HOLLAND. The current laws give us the power to supply that financial information to State bank supervisors and of course the management of the banks that we are criticizing. We do want to be able to go back to and tell the officers and directors of the banks we are criticizing the basis of our criticism and be as concrete as possible.

Mr. ST GERMAIN. Would you expand on that a little more for the record? The purpose of this is an attempt to perfect the legislation. We have three separate bills that we are trying to mold into a piece of legislation that would correct the problems yet which would not entirely do away with the intentional purport of the 1970 act.

When answering that question, keep in mind the infringement of the customer's right to privacy.

The next question: Since the IRS and SEC have the power to obtain financial data through two of the bills, H.R. 2152 and H.R. 1005, by administrative subpenas and summons, why is it necessary for the Federal Reserve Board to make information available to these agencies?

Mr. HOLLAND. They occasionally come and ask us for prosecution type information.

Mr. ST GERMAIN. What I am saying is that the legislation gives them administrative subpenas or a summons. They independently can obtain this information from the financial institutions, by going through the process of an administrative subpena or a summons.

Mr. HOLLAND. Yes. If you are referring to the paragraph where we suggested at the top of page 4 of our letter an additional insert to make clear that we can supply information to prosecuting or enforcing agencies, the principal agency would be the Justice Department, the U.S. Attorney's Office.

As we see that——

Mr. ST GERMAIN. That is my next question. Since the information that the Secretary of the Treasury would obtain pursuant to the act of 1970 and the rules therein relating to currency transaction which will

be of interest to Justice and since the act provides for disclosure of such information to appropriate agencies or departments—why is it then necessary for the Board to have the power to make such information available?

Mr. HOLLAND. If we are talking, now, only about the international financial information——

Mr. ST GERMAIN. No. We are talking about currency transactions that would be of interest of the Justice Department and not limited to international transactions.

Mr. HOLLAND. There is some currency information we have that the Treasury does not have. Information on currency shipments to and from the Federal Reserve Banks to member banks, the numbers of the bills or currency. Sometimes it is finding the numbers on a certain currency like that that enables the Justice Department to trail a criminal act.

Mr. ST GERMAIN. That would not be information on an individual depositor or customer of a financial institution?

Mr. HOLLAND. It might be an individual bank. It would be if we sent out a bundle of currency with a set of numbers on it to the bank, the bank then paid it out to the individual, and so forth. And Justice is interested, the prosecutor is interested in following the whole trail. That would be part of it.

Mr. ST GERMAIN. Would you supply for the record what other types of information in terms of customers' financial records, the Board makes available to the Department of Justice presently?

Mr. HOLLAND. We do it when particular cases arise. I would be glad to give you examples. Perhaps that is the most instructive way.

Mr. ST GERMAIN. That would be instructive. The whole purport of this is to help the subcommittee in its consideration.

Mr. HOLLAND. I appreciate that.

We have sympathy with the thrust of the legislation. We would like to see it enacted and be in force.

Mr. ST GERMAIN. That is what we are trying to do. Would a need for a showing of probable cause that a crime has been committed before an order to obtain financial records, cause great problems for administrative agencies in carrying out their enforcement functions?

You might want to answer that one for the record also.

Mr. HOLLAND. On that one, we may defer to the enforcement agencies themselves.

Mr. ST GERMAIN. To Justice?

Mr. HOLLAND. Yes.

Mr. ST GERMAIN. Do you see any problems arising from the restriction of H.R. 1005 and H.R. 2752 concerning the activities of State and local agencies?

In the answering of this the problem we are facing is one of jurisdiction primarily. Whether or not the Congress can legislate in these areas. If you would address yourself to that.

Mr. HOLLAND. I will give a nonlegal answer if you will permit it.

We were attracted to the idea of making the prohibition apply to everybody, Federal, State, local governments, private citizens, the profitmaking businesses, and so forth. We thought it was a basic, fundamental constitutional position. It was worthwhile making it as broad as can be.

Mr. ST GERMAIN. If there be no other questions from the members of the subcommittee, Governor Holland, we would like for you now to proceed with your prepared statement.

Mr. HOLLAND. As you suggested, Mr. Chairman, I will read part way through, then we can pause to take questions, and then move on to the next stage of the discussion.

STATEMENT OF HON. ROBERT C. HOLLAND, MEMBER, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. HOLLAND. It is a pleasure to be here and discuss in one sweep the whole broad range of bank regulatory and supervisory matters that your subcommittee is concerning itself with.

I say that without tongue in cheek. We have been through problems the past 2 years that call for sweeping and comprehensive review. We are glad to see the Congress active in it and interested in it.

We hope to cooperate with you in any way that we can.

We see that the need for a careful review of those factors that might adversely affect the stability of the banking industry has been recognized by this subcommittee and other committees of the Congress, by the Board, and by the other banking regulatory agencies.

As I reported to this subcommittee in my testimony of December 12, 1974, at the Board we have undertaken a careful analysis of the key problem areas that might tend to contribute to an undesirable degree of instability within the banking system and of steps that might be taken to reduce such proclivities.

A number of our colleagues in Government have been engaged in similar efforts as well. Many bank managements have also been thinking through the implications of recent financial events for their own institutions.

This degree of attention and concern regarding the health of our banking system attests to the critical role banking institutions fill in our financial system and economy, and it underlines the need to insure that no significant weaknesses impair their continued well-being.

Among those financial events of recent years that have given cause for concern, the failure of the Franklin National Bank looms large. The circumstances leading to the demise of the institution have already been publicly reported, and therefore, my statements on this matter will focus primarily on the role played by the Federal Reserve Board in cooperation with the other bank regulatory agencies.

During the period from mid-May to October of last year, the Federal Reserve Bank of New York provided emergency credit assistance to Franklin National Bank in amounts rising to a peak total of $1,767 million.

The actual amounts loaned to Franklin varied from day to day, depending upon its liquidity needs. The Franklin National Bank was a member bank of the Federal Reserve System; as such, it merited the privilege of accommodation at our discount window under the usual rules so long as it remained solvent, and we were advised by its primary bank supervisor that such was the case. The sheer size of the loans to Franklin, however was extraordinary.

The primary purpose of these loans to Franklin was to prevent the immediate or imminent closing of that institution because of its liquidity problems. We believed that the closing of a $5 billion bank such as Franklin could have precipitated other bank failures with resulting large losses for many individuals and businessmen and for the Federal Deposit Insurance Corporation.

The situation arose during a difficult period for financial institutions and financial markets; such a failure at that time could, in our judgment, have had serious adverse consequences for the stability of our Nation's banking system, and for domestic and international financial markets in general.

With these considerations in mind, Federal Reserve credit fully secured by Franklin National Bank collateral, was extended to Franklin to help offset the massive net withdrawals of funds that developed as that bank's difficulties became generally known.

Between May 8 and October 8, 1974, when the bank was declared insolvent, it suffered an outflow of funds amounting to $2.8 billion—over half its total footings. By strenuous efforts, the bank succeeded in reducing its loans, investments, and cash by $1.1 billion during this interval. The eventual $1.7 billion in Federal Reserve credit assistance was necessary to offset the balance of the outflow.

During their 5-month period, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Board of Governors, together with the Federal Reserve Bank of New York, the actual lender, were in frequent communication with each other in a joint effort to arrive at a permanent solution to Franklin's difficulties.

As you know, the Comptroller has the statutory responsibility of determining whether or not a national bank is insolvent. Upon such a determination of insolvency, the FDIC must be appointed as receiver.

The FDIC then proceeds with the winding up of the bank's affairs, seeking to achieve an orderly transfer of the insolvent institutions' assets and liabilities and as little loss as possible to the deposit insurance fund it administers.

In the Franklin case, the Comptroller began consultations in May and June with major banks that might be capable of, and interested in, acquiring Franklin by merger. In September he obtained the additional advice of a financial consultant in an effort to determine definitely whether the bank could continue as a viable, independent institution.

In July, foreseeing the possibility that Franklin might have to be declared insolvent, the Comptroller requested the FDIC to contact other banking organizations which were potential purchasers of Franklin's assets and to develop a plan to assist such a purchasing bank in a transfer of assets and liabilities.

The FDIC accordingly began negotiations with interested banks to draft an acquisition proposal upon which banks could bid competitively in the event Franklin had to be declared insolvent. Briefly, this plan, as it was developed, called for the FDIC as receiver of Franklin to transfer all of Franklin's deposits and certain other liabilities to an assuming bank; that bank would be allowed to select assets of Frank-

lin up to an amount which, when added to the purchase price bid, would equal the liabilities it assumed.

The assuming bank would be required to keep most of Franklin offices open for at least 30 days. On its part, the FDIC would indemnify the assuming bank against losses from unassumed liabilities; it would advance supporting capital to the bank in the form of a subordinated note; and in return for the New York Reserve Band surrendering its lien on the assets of Franklin that were transferred to the assuming bank, assume Franklin's obligations to the New York Reserve Bank, which would be repaid to the extent possible out of the remaining assets, but would in any event fully be repaid within 3 years whether or not sufficient collections had been made at that time.

This last provision assured that no loss would be incurred by the Federal Reserve System as a result of either its emergency lending to Franklin or the purcha[illegible] by the New York Reserve Bank of Franklin's foreign exchange contracts.

This latter purchase had been undertaken by the Federal Reserve on September 24, 1974, in order to forestall possible defaults on these contracts that could have further seriously weakened confidence in foreign exchange markets, which at that time already had been shaken by defaults by a well-known German bank and by a succession of public disclosures of foreign exchange losses by Franklin and other banks throughout the world.

During the summer, one after another possibility that would have permitted Franklin National to continue as an independent institution was investigated. By October 8, 1974, every reasonable prospect of that kind had been explored and found inadequate.

The Federal Reserve's loan had served its purpose of enabling Franklin to meet its day-to-day liquidity needs up to that point, but the total was approaching the limit of available collateral.

The FDIC's contingency plan for the transfer of Franklin's assets and liabilities was ready. In those circumstances, the Comptroller declared the bank insolvent. The FDIC as receiver thereupon proceeded to implement its plan. The outcome of its negotiations with possible purchasing institutions was that the European-American Bank & Trust Co., purchased assets and assumed certain liabilities of Frankiln National.

An orderly transition has followed, although it will be some time before all aspects of this transition will be finally completed.

While in the end Franklin can be said to have failed, the provision for the uninterrupted continuation of its banking services through a successor institution minimized adverse repercussions.

Cooperation am[illegible]g the Federal bank regulatory agencies, combined with consultation with the Treasury and the New York State Banking Department, was instrumental in producing the results I have outlined.

Each agency had a distinctive role to play, and each role generated its own concerns. We at the Federal Reserve were especially interested in the adverse market attitudes and questions about banking soundness that were being generated as the Franklin case dragged on.

We were concerned as to Franklin's vulnerability to any new shock that might come along. And we had a painful awareness of how

Franklin's debt to the Federal Reserve kept climbing closer to the probable maximum loan value of the acceptable collateral which the bank could provide.

For those reasons we at the Federal Reserve urged that remedial measures move forward as promptly as they could. The Comptroller and the FDIC, respectively, with their own statutory obligations to consider, had to effectively exhaust alternative solutions short of receivership and to document liabilities and minimize losses insofar as time and circumstances permitted.

It should not be surprising that on occasions during those months that the agencies found that their preferred priorities for actions differed. When such instances became significant, however, hard work and good will overcame them. Fortunately, no new external shocks developed, and by the time Franklin was determined to be insolvent a detailed and well-integrated plan for its succession unfolded effectively.

As nearly as can be judged at this stage, not a cent of depositors' or taxpayers' money is expected to be lost in the process.

Although the Franklin National case was concluded successfully, experience made it clear that increased attention needed to be paid to stronger preventive and followup measures to reduce the possibility of similar situations arising.

Accordingly, the Federal Reserve System strengthened its program covering banks under its jurisdiction to place increased emphasis on the identification, surveillance and timely resolution of current and potential problem bank cases. This action had first priority among the broad sweep of studies addressing key problem areas in banking supervision and regulation that I described in my testimony before the subcommittee last December 12, and about which I will be reporting to you later in my testimony today.

Briefly each Reserve bank was asked, among other actions, to make special efforts to identify member banks in its district which were or might be facing difficulties with regard to the quality of their assets or the balancing of financing needs with the prospective availability of funds.

Second, with respect to State member banks, a greater than usual concentration of Federal Reserve examiner time and attention was to be devoted to identified problem banks during the remainder of 1974 and also through the year 1975. In each such problem bank case, an appropriate and specific program for remedying its difficulties was to be established including, if need be, direct discussions with the bank's directors to confirm the commitment of top management to that task.

Third, any member banks experiencing unusual liquidity difficulties because of a runoff of money market funds or because of public concern about the condition of the banks were to be informed of the basis on which accommodation at the discount window would be made available.

The Federal Reserve has thus taken requisite administrative steps to insure that greater emphasis is placed on identifying, monitoring, and following up problem situations. It is humanly impossible and even undesirable—for supervisors to prevent all bank problems; but it is practical to aspire, as we do, to recognizing the problems early and moving promptly to try to remedy them.

There remains, however, a gap in the range of feasible remedial actions that could be undertaken if preventive measures should somehow not succeed in forestalling a bank failure. In that eventuality, the most desirable ultimate action in most cases is for the bank to be taken over by another bank. Bank mergers, where permitted by State branching law, can sometimes serve this purpose effectively.

The alternative of bank holding company acquisition of a failing bank, however, even where permitted by State laws, is substantially inhibited by two Federal statutory constraints. One enforces certain time delays in the approval and consummation of all bank holding company acquisitions. The second effectively prevents any holding company acquisition of banks across State lines.

In our view, either or both of those limitations can interfere with actions needed to protect the public interest in some cases. Accordingly, the Board recommended to the Congress substantive measures, statutory changes, now embodied in H.R. 4008.

Before I go into further detail about that legislation, I would like to respond to any question you have about Franklin and the problem banks, more specifically.

Mr. ST GERMAIN. Since the technical insolvency of most major banks is due to market value of portfolio, being less than book market, is it possible to establish a more realistic standard of insolvency without resulting in all major banks being declared insolvent?

Mr. HOLLAND. Mr. Chairman, as we look at a bank, and whether or not it is insolvent, we do not believe that the immediate market value for all of its assets is always the best way to judge what that bank is worth, whether it is in fact, insolvent. Financial intermediaries, this includes not only banks, but other types of financial intermediaries, have assets that oftentimes have poor secondary markets. We go through some pretty big financial swings in this country, good times and bad. Sometimes market prices can rise pretty high or drop pretty low.

Mr. ST GERMAIN. In Franklin we had questions on their securities portfolio, right? At the same time that everything was going or falling, there was a tremendous drop there.

Mr. HOLLAND. Oh, yes, that unfortunate organization, as it reached the end of its rope, seemed to try to redouble its bets to offset losses in its securities operations, which made it that much harder to save.

We think that it is better to look at a bank in terms of its ongoing value. We believe that these up and downs in market values, while they have meaning if you want to try to sell all assets in a moment, are not meaningful if the organization is going to be there and continue to function day after day, week after week. We think that it is better to look at the underlying value, the realizable value over time of those assets, in judging whether or not the bank is insolvent.

It has not always been this way. Before 1938, examiners of banks did oftentimes use current market value to judge whether or not the banks were insolvent or should be criticized.

In my opinion, it was one of the things that exacerbated the Great Depression from 1929 to 1933 and some of the financial pains and losses, and the sharp decline in market values that came out of the depression. Examiners in dealing with individual banks were writing

down values, saying that wipes out your capital. Oftentimes this approach precipitated into insolvency organizations that were trying to take care of their community.

As we among the Federal regulatory agencies look back on that experience, we concluded we were making things worse, not better.

In 1938, we produced a joint agreement among the three Federal banking agencies that we would value the assets on an ongoing underlying value basis, so long as there was reason to think that the bank was, in an ongoing condition.

However, when the bank is about to fail, you have to recognize you may have to realize immediately on those Government securities that may be selling at 90 cents on the dollar even though you know Uncle Sam is going to pay them at maturity.

Short of being right at the brink of failure, we believe that ongoing value, the recognition that such assets will be paid at maturity, is a better and fairer way of valuing what the bank is worth, what equity it has. We are quite sure that that keeps them in a position to better serve their community and their customers.

Mr. ST GERMAIN. As you know, there is great interest in maintaining a stable banking system, especially since the recent failures. How extensive do you see the regulatory agencies' role here in being able to involve itself in the competence of the bank's management. I would also like to say that when we look at U.S. National, we will see dominance of one individual in a bank's management. Then there is the competence of bank management in the Franklin case, especially when you look at the fact that Franklin between 1950 and 1962, their assets went from $50 million to $1 billion, and their earnings between 15 and 20 percent of stockholder equity. Yet we are told management was unsophisticated and incompetent. When we look at the history of U.S. National of San Diego, we see that despite constant admonitions in the early 1960's about the dominance of one character, one individual, and self-dealing, that no action was taken because—these are the answers we received—they said, well, the bank kept growing and growing and growing.

So, what do you feel the role should be at this point as to the supervisory agencies when looking at the competence and the ability of management when faced with a situation where there is a dominant individual? I think, frankly, we might say from some questions I will ask a little later on, that there was a dominant individual also, in the person of Mr. Sindona.

Mr. HOLLAND. We and the other regulatory bank agencies also endeavor to evaluate management as a part of each examination. Part of the rating that we give to a bank at the end of an examination depends on what we think of its management. We have reinforced our efforts to make that management judgment objective and fair. We have learned something, and I think everybody in the banking business has learned something in the last few years. Banks by and large now are being run by a generation that did not live through a major banking problem. This generation grew up, went to college, and had its business experience after the great bank shakeup of 1929 to 1933. Indeed, we knew the banking system was different in some important ways from 1929 and 1933 in part because of some of the supportive

legislation enacted by the Congress. That meant it was a little harder to judge where is the edge of risk beyond which one should not go, where are the limits of prudent banking and competent bank management. Our examiners did try to make that judgment themselves as they appraised individual cases. The experience of the last several years has made clear there are limits in this new banking world that have to be observed and activities beyond those limits have to be criticized. We are now trying to do that.

Mr. ST GERMAIN. Have you or the supervisory agencies taken any definite steps, or have you arrived at a conclusion as to how to handle this at this point?

Mr. HOLLAND. We have done some things; we are about to propose a couple more things to you. We have told our own examiners, watch this carefully, reinforce your attention to problem bank cases, cases where we see signs of danger. We include as a problem bank case a bank that was poorly managed. That is a part of our judgment of what is a problem bank. Nowadays, we have told our bank examiners where you find a management that is not doing well and is running a poor bank, and they are not seeming to straighten up after criticism to be even quicker than before to take that management and go with them to the board of directors of that organization. We have told them to sit down before the members of that board, point out the directors' liability for maintaining an ongoing institution, and work with the directors to get the management to shape up the organization and remedy some of its deficiencies. We have been doing that more aggressively within the last year.

Mr. ST GERMAIN. Does the examiner have a direct line, let us say, to the Federal Reserve Board, to the Comptroller, to the FDIC, or to Mr. Wylie, at this point?

Do you hear about this at the same time that the examiner is going to the board of directors?

Mr. HOLLAND. I do not, personally.

Mr. ST GERMAIN. What about the supervisory agency?

Mr. HOLLAND. Oh, yes. We have told them to alert us when they hit a problem case. Moreover, since we were last here, Mr. Chairman, we worked out an agreement with the other agencies to share early notice with each other when any of us finds what we think is a problem bank case that may be related to another bank which is under their supervision. So, we are sharing information on problem cases more quickly than before.

Mr. ST GERMAIN. Quickly, because my time has expired—I have 3 seconds—you mentioned, I think, 56 problem banks on your list at this point.

Mr. HOLLAND. Yes.

Mr. ST GERMAIN. How many of those problem banks are banks where you have problems with incompetent management or overdomineering management?

Mr. HOLLAND. I would have to check to give you an answer. I would be glad to do so.

Mr. ST GERMAIN. For the record.

Thank you.

[The information is contained in the Fed's response to the subcommittee dated September 8, 1975, and may be found in appendix A.]

Mr. Moorhead.

Mr. MOORHEAD. Thank you, Mr. Chairman.

Under the new procedures—if the new procedures that you have established had been in existence, do you think you would have found out about the Franklin's problems sooner in time to prevent the necessity of the takeover?

Mr. HOLLAND. If I may point out, Mr. Congressman, we were not the primary supervisor of Franklin. It was, as a national bank, subject to examination by the Comptroller. For all national banks, although they are members of the Federal Reserve System, we step aside and the Comptroller's examiners examine them and give us copies of their examination report. I should really defer to him for a response to that question.

I would like to try to be responsive by speaking more generally, if I may. My own feeling is, one of the biggest shortcomings that stands out as one looks back with 20–20 hindsight on these situations was in the followup. We have had one or two that have been troublesome, so I do not mean to suggest that things worked out fine for all the Federal Reserve examined banks. Maybe the examiner in the field was aware of something wrong and noted it in his reports. But the effectiveness of the followup would have been better if it had been stronger and quicker.

We have tried to alter our examination procedures in order to speed the followup on any problems that our examiners turn up when they get to a bank. Part of the followup is going back and sitting down with the board of directors. If the management has not given us satisfactory answers on how they plan to solve a problem, we are telling our examiners to go back sooner to a problem bank for the next examination and get the examination report out earlier. Go back quicker; take the president of the Federal Reserve back with you if the management and directors are not listening to you. We will unleash the biggest horses we have to move into that organization to be sure that it does agree to change. I can say to you that we believe we have had a salutary pickup in responsiveness as a result of this stronger program.

I do not want to claim entire credit for the success of that program. The troubles of the last year or two have made bank managements more responsive to examiner criticism than they were in years before.

Mr. MOORHEAD. Once Franklin got into trouble, am I correct that one solution, if the law had permitted it, would have been for an active New York holding company to have acquired the assets, but the law prohibited it. Is that correct?

Mr. HOLLAND. The law did prohibit it at this time; except no bank outside of New York except an international organization could do it.

Mr. MOORHEAD. How about inside New York?

Mr. HOLLAND. Inside the State of New York?

Mr. MOORHEAD. Yes.

Mr. HOLLAND. The bank would have had to be inside the district in which branching was allowed in order to be able to acquire the assets and take it over immediately.

Mr. MOORHEAD. Ultimately, the takeover had to be by a foreign-controlled institution, is that correct?

Mr. HOLLAND. Or one of the titans in New York City itself: that would have been the other alternative. Let one of the three or four biggest banks in New York City buy it or take it over.

Mr. MOORHEAD. Legally, it would be close to violating the spirit of the antitrust laws.

Mr. HOLLAND. We certainly thought that it would have been. If one of the very largest banks in New York had acquired the deposits, the facilities, the customers of Franklin, it would have worked to reduce competition. Those Franklin branches throughout the area are very valuable banking commodities; they are a key to very large Long Island deposits in that capital surplus area. They would have been a very attractive addition for one the biggest banks in New York City. We would have regarded it as an adverse competitive acquisition, a very adverse competitive acquisition.

I am glad it did not turn out that way.

Mr. MOORHEAD. Would that have been permitted under the bill that you are endorsing? H.R. 4008?

Mr. HOLLAND. It would not have been legally ruled out by H.R. 4008, but we and the FDIC would have had the alternative of considering a bid from one of the other strong holding company banks around the country to take it over, and thereby to become a new and vigorous competitor in New York City.

I should not speak for the whole Board. I believe in the Franklin case that would have been a much more procompetitive acquisition than letting one of the very biggest New York banks buy it.

Mr. MOORHEAD. Would you also say that you would have favored that over the acquisition by a foreign controlled institution?

Mr. HOLLAND. Well, that is harder to say. I think I would have to look at the circumstances on that one, Congressman. The European-American foreign controlled organization that did buy it was partly in competition with some of Franklin's operations, so it, too, had some anticompetitive influences. It was a smaller organization. On its own resources, I do not believe it could have handled the acquisition; it needed the backup. It is a $2 billion organization.

Mr. ST GERMAIN. Will the gentleman yield?

Mr. MOORHEAD. I yield.

Mr. ST GERMAIN. Who makes up Inter-American?

Mr. HOLLAND. The power of those multimillion dollar foreign owners, the power and management know how that gave it the capacity to move in and make a credible bid for this organization.

We would certainly have liked to have been able to consider a competing bid from a major organization from one of our other States—Illinois, California, Pennsylvania—some of the States where we had some other really big, strong banks—as an alternative to that acquisition. I believe the Government would have saved some money, the FDIC would have saved some money, because I suspect the final sales price would have been a little higher.

Mr. MOORHEAD. Your testimony was that the FDIC did not lose any money.

Mr. HOLLAND. No, they have not. You are right. When I say saved money—their chances of losing money would have been even less.

Mr. MOORHEAD. I see.

Thank you very much, Governor.

Thank you, Mr. Chairman.

Mr. ST GERMAIN. Mr. Rousselot.

Mr. ROUSSELOT. Mr. Chairman, I regret that Mr. Wylie left because really, in the order of things, he had been here prior to my time.

Governor Holland, we appreciate your taking the time being with us. Some of the questions we ask are obviously, as you know, a result of questions we get from all over the country. I hope you understand that this is our opportunity to try to reflect what other people ask. It may be the truth or half-truth; we do not always know, ourselves, how to get the full answers.

In your statement on page 4, you said that the Fed's borrowing through the discount window was "fully secured by Franklin National's bank collateral."

We have a lot of "experts" that have come into the banking field who write books and articles. One is Martin Mayer, whose book, "The Bankers" has received a lot of attention. I do not know if this quote I am going to give you is very factual; at least I will give it because it has received attention, and ask if you would care to expand on your discussion concerning this quote from Mr. Mayer.

He said in his book, on page 115, "During the height of the agitation, this tourist"—meaning himself—"had occasion to say to a very senior officer of the Fed of New York that it would be fun to watch the Reserve bank try to dispose of that collateral if Franklin were declared insolvent." Then he said, "Martin, you're not entitled to that much fun."

I do not know who the senior officer was; we are not privy to that information. I do not know if this is a sensational statement.

Can you comment on that statement?

Mr. HOLLAND. I tried to find out who that fellow was to ask him what he meant by that rather cryptic remark.

Mr. ROUSSELOT. If you find out, let us know and we will invite him to come in to testify.

Mr. HOLLAND. I have not found out.

I know the spirit in which we handle it—collateral. We are required under law, to lend only when the loan is satisfactorily collateralized or endorsed. This collateral is a matter of statute, and I am glad we have it. It helps us act as the lender of last resort, knowing that we have some value to fall back on if a borrower, in the end, is not able to repay himself. We hoped all during that interlude that we would not have to realize on that collateral; something would happen that would turn the situation around and gradually get paid without having to realize on collateral. Realizing on collateral is a long, painful business. It is not fun when you have to do it. I have done it a time or two, and it is a pain in the neck. It may be that kind of outlook that was leading that officer to say what he did.

Mr. ROUSSELOT. I hope we do not have too many more quotes like that around.

On page 10 of your statement, you said, "As nearly as can be judged at this stage, not a cent of depositors' or taxpayers' money is expected to be lost in the process."

In addition, President Hayes, in response to a question I submitted to him in writing and in a part of the committee's hearings on Federal Reserve policy, held in August 1974, said, "The net monetary impact of all transactions related to the stepup in Franklin's borrowing was negligible."

My question is, Where then was the impact of the $1.7 billion loss felt? Was it to be borne by consumers of banking services?

Mr. HOLLAND. Let me try to answer this in two stages, Congressman. We loaned them up to $1.7 billion——

Mr. ROUSSELOT. Yes, we know that.

Mr. HOLLAND. We charged them interest on it, so we earned interest to cover our costs. When they finally went insolvent, the assets that we had as collateral we sold to the FDIC and they are going to collect and pay us back. We know we are not going to sustain a loss out of that loan.

With respect to the monetary effect of that $1.7 billion, when we loaned them the $1.7 billion, they, in effect, turned around and paid it out to depositors, creditors who were pulling money out of their organization. Those people, businesses, financial institutions in Long Island and New York City, some of them around the world, took that money and we presume—we are not able to trace it—they redeposited it in other institutions, used it in other places, reloaned it elsewhere and so forth. That is where the $1.7 billion went.

From a point of view of overall monetary policy, we had an additional problem. When we lend money, we create bank reserves and bank reserves are a part of monetary policy. Perhaps this is what Mr. Hayes was driving at. As we loaned that extra money to Franklin, we told our Government securities trader to sell Government securities in the market to absorb reserves in an amount sufficient to offset the amount of reserves we were creating by lending money to Franklin. In that sense, the net monetary policy impact was negligible.

Mr. ROUSSELOT. How much did they have to sell to break that up?

Mr. HOLLAND. They sold $1.7 billion. We reduced our holdings in Government securities about as much as we increased our holdings in Franklin National promissory notes.

Mr. ROUSSELOT. When you sell those, where do you normally sell them?

Mr. HOLLAND. We sell them in the Government securities market.

Mr. ROUSSELOT. The private market, primarily?

Mr. HOLLAND. Yes. The competitive market in which traders bid for securities; the standard market in which we sell our Government securities.

Mr. ROUSSELOT. Is this mostly debt securities? Government securities?

Mr. HOLLAND. Entirely Government securities.

As it turned out, and we look back on this situation; we—at least I—have concluded we may have worked a little too hard to make those numbers match precisely to sell the right number of Government securities to offset dollar-for-dollar what we were lending to Franklin. At the time, we thought that was the way to neutralize the net monetary effect.

More recently, some work that I have been aware of and some reflection that I and my colleagues have been doing leads us to believe that we probably underestimated the worry and the concern and the consequent tendency to hold back what the Franklin Bank episode created among all kinds of people in the financial market and the banking business—borrowers, customers, so forth. Therefore, there

was kind of a restraining influence at work that came out of the Franklin troubles.

Therefore, we might not have needed to work as hard as we did to offset every dollar of reserve, since there was a restraining hand of extra uncertainty that was dampening things down at the same time. That is hindsight, trying to learn for the next time around. It is a subtle influence, not a major one.

Mr. ROUSSELOT. My time is expired. I have some additional follow-up questions; I will wait until later.

Mr. ST GERMAIN. Governor Holland, when you lent that money to Franklin, what was the rate that Franklin was paying?

Mr. HOLLAND. For a good bit of that interval they paid our regular discount rate.

Mr. ST GERMAIN. Which was approximately what?

Mr. HOLLAND. At the moment, the number escapes me.

Mr. ST GERMAIN. Would 6 percent be within the range?

Mr. HOLLAND. Yes.

Toward the latter part of that period, however, we created a new emergency lending rate structure, charging them a higher rate than our regular discount rate.

Mr. ST GERMAIN. A great deal of it was at the regular discount rate?

Mr. HOLLAND. Oh, yes.

Mr. ST GERMAIN. What was the rate in the Federal funds market at that particular time?

Mr. HOLLAND. Running well above those rates.

Mr. ST GERMAIN. Fifteen percent, was it not?

Mr. HOLLAND. It never got to 15; to got to a high of 13 on an average in June. It went back down a bit from that.

Mr. ST GERMAIN. Franklin was, during that period, able to put some of that money into the Federal funds market, was it not?

Mr. HOLLAND. No, Mr. Chairman. They did not lend any money to the Federal funds market. They were using all that money to pay withdrawals and repayments. They were getting money from us cheaper than the going Federal funds rate.

Mr. ST GERMAIN. Perhaps I have been misinformed. My information is during that period of time when they were getting 6-percent money at the discount window, they were in the Federal funds market, where the rate was practically twice the rate that they were paying.

I would like you to look that one up very closely and see if in fact my information is erroneous.

Mr. HOLLAND. There might have been a day or two in that period when they found themselves with a little money over at the end of the reserve period and sold on the funds market. Frankly, I would be surprised if that happened. They needed more money than they had virtually every day. We would adjust the amount of their note each day to fit the amount of money they needed to close the gap between what they had plus what they were able to scrounge up themselves and what they had to pay out to satisfy the claims against them. They were borrowing in the Federal funds market, Mr. Chairman, and paying a higher rate borrowing in the Federal funds market than on the money they were borrowing from us all during that interval.

Mr. ST GERMAIN. As we know, the salvaging effort at Franklin was not successful. The subsidy that was provided through the discount window accrued to the benefit of a great many of the big depositors, did it not, because the word was out on the street that Franklin was in trouble?

Do you know how many of the large CD's were drawn during that period of time when quite a few people, sophisticated depositors, became aware of Franklin's plight? Do you know exactly what was withdrawn during that period of time that the Fed was pumping in that $1.7 billion?

Mr. HOLLAND. In a rough kind of way, yes. We have a breakdown of how much their large CD's went down, how much their Federal funds went down. We also knew they began to lose demand deposits, some out of their Long Island branches. The largest share of their money that they lost, of the $2.8 billion, the total they lost was large denomination, interest-bearing money or deposits or liabilities. There was a fair amount——

Mr. ST GERMAIN. You mean amounts over the FDIC insured rate?

Mr. HOLLAND. Over $100,000. A fair amount was oozing out in smaller denominations, too, as time went on. The word was out, not just to the sophisticates who could read it in the New York Times every few days.

If I may, Mr. Chairman, I would like to say a word on this question of subsidy.

Oftentimes, at first blush it seems to be a subsidy when you lend—when the Federal Reserve lends to a member bank at a rate lower than the Federal funds rate that would have to be paid to someone else in the private funds market. I ask you to recognize that that rate is not the only cost that a bank incurs when it becomes a member of the Federal Reserve and then borrows money. In effect, every bank that is a member of the Federal Reserve System has been putting up, day in and day out, as long as it has been a member of the Federal Reserve System, assets as reserves with us it otherwise could be earning money on. It has been foregoing earnings on the reserve balances it leaves with the Federal Reserve. Indeed, those lost earnings have been so sizable that sometimes you read about banks withdrawing from the Federal Reserve System because they cannot afford that cost.

One of the privileges they get in exchange for forgoing the earnings on those assets represented by reverses is the privilege of borrowing at the discount window. It is kind of analogous, I think, to belonging to a club where you may get a lunch at the club for a dollar less than you would have to pay at a restaurant next door. You may have to pay $500 a year dues to the club. Would you call it subsidy that a club charges you a dollar less for lunch? That is about the kind of relationship we have with our member banks.

We try ordinarily to keep our discount rate fairly close to market rates. We do not try to keep it below.

During that period last year, money was already so tight, the financial system already under such strain, we did not want to raise our discount rate up to the Federal funds rate.

Mr. ST GERMAIN. There is one case where Franklin made a syndicated loan to Creditop—an Italian institution involved in public

finance—and had to disburse approximately $70 million in funds in excess of its legal lending limit of $20 million loans to one borrower. Franklin received a fee of $300,000 for the underwriting, $100,000 of which was paid to Sindona for a finder's fee. When the bank was found to be in excess of its legal lending limit, Mr. Sindona agreed to take the excess to a lending unit of his Italian real estate company, and it was shifted to Mr. Sindona's company, and $80 million was deposited in that company by the London branch of Franklin Bank. That came out in a perspectus that Franklin filed with the SEC in March. The result of this very intricate maneuver was that Franklin continued to fund the loan to Creditop in excess of its legal limit and involved itself in substantial self-dealing with Sindona.

Subsequently, the deposit was withdrawn at the insistence of the bank's executive committee.

When one views that, would this not be one of those classic abuses of managerial responsibilities of banks' self-dealing, similar to much of what occurred in U.S. National of San Diego, on an international scale rather than that of Mr. Smith who was on a local level?

Mr. HOLLAND. If I may answer in general, I would say yes. I should defer on the specifics of that transaction. I believe, to the Comptroller who was on top of it and whose regulations were being challenged with these maneuvers.

Mr. ST GERMAIN. How can you defer? You did pump $1.7 billion into Franklin; thereby you should have known a little bit about these transactions.

Mr. HOLLAND. We knew a lot about the $1.7 billion collateral behind that loan. We had credit analysts pouring over the notes we had to assure we had ones that were as good, as solid a credit basis as we could find.

This particular action, as I recall, took place before we got into the picture as a lender.

Mr. ST GERMAIN. Governor Holland, we have to go to the floor for a vote. We will be in recess for approximately 10 minutes. At that time, if Mr. Brown wishes to return, we will call upon Mr. Brown for questions.

[After recess.]

Mr. ST GERMAIN. The subcommittee will come to order. We are awaiting the other members to return, Governor Holland. I would like in the meantime to bring up again a question that was brought up by Mr. Moorhead. Frankly, I was hoping we would stick to Franklin instead of going on to the subsequent portion of your testimony. Underlying your recommendation relating to emergency mergers and acquisitions as far as the legislation sent up by the Fed that I introduced by request is concerned, is the following assumption valid that in the case of a potential failure of the large banks, only one bank holding company should take over the problem bank? Is it sometimes possible to spin off the assets and liabilities among several banks, rather than to one large one?

Mr. HOLLAND. I can think of several times that we have looked at that as a possibility. I say we—I am using the collective we—the FDIC, the Federal Reserve, and the primary supervising agency, have thought about doing it. It was one of the possibilities reviewed

at some stage in Franklin. Very often it is an unappetizing package to a buyer. The idea of taking only a part of the organization means that they lose some of the attraction, the customer contact, customer service, and so forth, that makes them willing to take on what is a headache.

Mr. ST GERMAIN. When we look at the acquisition of Franklin, we know that in reality the acquisition was by a group of some of the largest banks in Europe.

Mr. HOLLAND. Oh, yes, no question about that.

Mr. ST GERMAIN. We are letting foreign banks do what is not being permitted—I do not know—by our domestic banks.

Mr. HOLLAND. That seems incongruous to us. It just does not make sense to let foreign banks do what we will not let our banks do.

Mr. ST GERMAIN. Getting back to self-dealing, in the case of Franklin when we look at the examination of June 1974, the examiners then found that all loan deposit relationships between Franklin and Sindona-related enterprises were within the legal limits based on the banks' capital accounts before foreign exchange losses. However, the examiners reported a total of $297 million of outstanding foreign exchange contracts with Sindona-related banks, $70 million more than the bank's capital funds of $226 million. These events raise a number of questions. Were those foreign exchange contracts legal, both in the terms of existing limits on loans to one borrower and existing restrictions on self-dealing? No. 2, were the examinations of foreign branches adequate to reveal the self-dealing of the type that is revealed here?

Mr. HOLLAND. Again, you are drawing on the Comptroller's examination report of which I have only a generalized acquaintance. I think I can say a couple of things on the general point you are making. It is a valid point, I think, in looking at these arrangements.

The most difficult problem in the unwinding of the Sindona relationships in general, particularly the Sindona relation to the foreign exchange contracts, was that it was very hard to know when a name represented a Sindona interest and when it did not. It was very common for him to have a wide number of corporations, personal corporations, organizations of one kind or another, in which his interest might in some cases be full stock ownership, in some cases be part stock ownership, and in some cases ownership of a percent that, by our standards, would not amount to control. Nonetheless, apparently, he led that organization to operate in some degree of concert with others.

In looking at those foreign exchange contracts, it was very difficult sometimes ever to be sure whether or not there was a Sindona-related firm on the other side. I daresay there were some where we never figured it out.

Mr. ST GERMAIN. Yet, these foreign exchange contracts for the most part—in fact, they were almost all with Banco Unione, which was a known Sindona bank.

Mr. HOLLAND. Recognizing that one was not a problem, I was addressing myself to the more generalized question of how you deal with the insider trading problem.

Mr. ST GERMAIN. With regard to foreign banks which are operating with branches here and U.S. banks, operating in foreign countries, do you feel as though there is sufficient examination by our regulatory

agencies of these foreign branches? Do you think it is necessary to know what is going on?

Mr. HOLLAND. I think the right answer to that now is yes, but I must say since this episode with Franklin and some foreign exchange losses at other banks too, we have been at work looking at the foreign exchange departments of our banks and also at some of their foreign branch operations, we have reviewed our examination procedures, and the Comptroller has reviewed his as well. We have intensified some of our examination works and the amount of checking on foreign activities. That process of tightening up examination procedures is still underway. We have not examined all of the branches of State member banks. I believe the process we have launched will result in a reasonable degree of examiner surveillance when it is completed.

There is one other caveat I have to add. In some foreign countries we cannot physically enter to get the information.

Mr. ST GERMAIN. Let me ask you this. Prior to Franklin, to your reawakened interest, is it not a fact that information provided by our domestic banks operating in foreign countries was inadequate, or at least was nowhere near the type of information that you were receiving as a result of your examinations of the parent banks in this country?

Mr. HOLLAND. It was not as much or as frequent. We were getting some, we were getting a fair amount, including material we could look at at the head office.

Mr. ST GERMAIN. How long after the examination do you get the material at the Fed concerning the foreign branch?

Mr. HOLLAND. I do not know. I would have to check to let you know.

Mr. ST GERMAIN. I think you would find it is a rather lengthy time period.

Mr. HOLLAND. I believe it is shorter now than it was a year ago.

Mr. ST GERMAIN. When you say that there are restrictions in foreign countries as to the amount of examination, that can be entered into by our supervisory and regulatory agencies, that being the case, why do we allow our domestic banks here to establish that branch in a country where you are not allowed to perform a complete and adequate form of examination? Does not that branch—and this is no longer speculative, it has happened—does not that particular branch in a foreign nation and its activities have a very definite relation to the soundness of the parent bank here?

Mr. HOLLAND. Oh, yes. We found that in the Franklin case, as you well know. The London branch of Franklin was a sizable part of its operation. Its risks, its loans in London were not particularly troublesome in terms of poor quality, final payout prospects; they were troublesome in terms of the legal entanglements of getting free of obligations and realizing on loans or even taking them as collateral for our lending. We believe in general, the process of letting American banking move overseas ought to proceed under the philosophy that our banks abroad ought to be able to meet their foreign competitors on reasonably even terms. We have allowed things that domestically are not permissible if the particular foreign country permits it. We have looked to the foreign country to set the standards within which banking activities go on.

What we are doing now is providing a little more of our own backup to be sure, than we did heretofore, and, besides, we are checking more frequently. The overall records of foreign loans of U.S. banking operations is not bad. We did a study a couple of years ago and found the loss ratio from foreign operations was no worse, in fact, statistically, maybe a touch better, than the loss experience in domestic credits. That was before the 1974 shakeout and the numbers may have changed.

Mr. ST GERMAIN. Here, you have an example of self-dealing with Sindona by the foreign branch of Franklin that would not have been permitted in the United States.

Mr. HOLLAND. The management, itself, said that should be taken out of the domestic office of Franklin, as I understand it.

Mr. ST GERMAIN. Put it over there where it is allowed, since it is illegal here, thus they moved it over. That is very similar to what Smith was doing with his loans. In order to stay ahead of the examiners, he farmed them out to correspondent banks.

Mr. HOLLAND. That kind of insider trading is to be deplored. I would say this in comparing the two cases. I would generalize by saying that there was a lot more insider trading relatively and absolutely in U.S. National than has been turned up as far as I know to date in Franklin.

Mr. ST GERMAIN. Is it a matter of degree, Governor Holland? If it is wrong, it is wrong no matter what the degree.

Mr. HOLLAND. If it is wrong, it is wrong, I agree with you.

Mr. ST GERMAIN. You have not answered my other question. That is why do we allow our domestic banks to establish branches in foreign countries where we cannot subject those branches to the same examination process that they are subjected to here?

Mr. HOLLAND. The comment I made earlier about broad philosophy is a generalized response to that. We, in general, have tried to let our banks abroad operate as nearly as we could on the same terms and conditions as were applicable to the foreign banks across the street that they are competing with. That argues in a number of countries where less strict surveillance is used than we use here at home, that we let our banks work under that more relaxed surveillance. It is not really fair to simply say, relaxed surveillance. Perhaps, it is more appropriate to say less objective surveillance. A good many foreign countries do not rely as much as we do on objective reports and examinations, but rely more than we do on calling in managements and having quiet conversations, and that kind of a sort of more subjective qualitative fencing in of activities. Our tendency is to regard that approach as not as good as ours. Some of our colleagues abroad claim it is better.

Mr. ST GERMAIN. Yet, here in the United States of America where we have 50 States do you apply the State banking examination procedure, rules and regulations, or do you apply those of the Comptroller, the Fed, the FDIC and the Home Loan Bank Board?

Mr. HOLLAND. We hit them with everything they are subject to. As State member banks they have to comply with all of the State laws, in addition having to comply with all of the Federal Reserve Board laws and regulations.

Mr. ST GERMAIN. Is that not inconsistent overseas? You can do whatever they allow you to do there? If you stay here, you have to comply

with what we say in order to be competitive overseas, yet if you go in State A, B, C, or D, we do not care about the competition there, you have got to live up to the real standards and regulations and statutory requirements of the Federal banking system?

Mr. HOLLAND. So do the other banks that are in States A, B, C, or D. It is in that sense that we are trying to reach a measure of competitive equality. We do not do it perfectly, Mr. Chairman.

Mr. ST GERMAIN. If that were the case, why do we have two entirely different systems of examination? You have State bank examiners, and you have Federal bank examiners. That is one of the problems we are looking at right now. They are conducting an experiment in Indiana to see if they can live up to the Federal criteria. To say the criteria is the same between a State chartered bank and a federally chartered bank, I do not think is accurate.

Mr. HOLLAND. It is inefficient to have those overlapping supervisory systems. We do it in the name of dual banking system, in the name of checks and balances. When U.S. banks go overseas, their foreign operations are essentially subject to the foreign rules and regulations, but we have also added some. Some things are ruled out that would be permitted in some foreign countries. Thus far, we have placed a lot of reliance on the rules and regulations of the countries in which they are operating.

Mr. ST GERMAIN. Up until recently the information obtained as a result of the examination of branches in foreign countries has been nowhere near as complete as it has been for the parent banks in this country.

Mr. HOLLAND. It has not been as complete and we have not had as much information. That is right.

Mr. ST GERMAIN. It is slow in coming in.

Mr. HOLLAND. I said I would check on that. I suspect when I answer you, I will say it is slower than what we get at home.

Mr. ST GERMAIN. Mr. Rousselot.

Mr. ROUSSELOT. Thank you, Mr. Chairman. Mr. Holland, I would like to go back to this collateral that the Federal Reserve Board had. What was your judgment as to the quality of that collateral? Realizing this is hindsight now, have you had a chance to look at the quality of that collateral?

Mr. HOLLAND. I have the chance to benefit from the appraisals of our credit analysts. I saw a bit of it physically. For the most part I will be relying on what our credit analysts said. We had a team of credit analysts go over all of that collateral.

Mr. ROUSSELOT. On the basis of what they provided, what would you say the quality of that collateral was at the time it was held?

Mr. HOLLAND. The right word for it was it varied. There were some notes that were very good. They still had some Government securities and some good municipals and so forth. They ranged down to mediocre. There was some stuff so poor we would not take it as collateral.

Mr. ROUSSELOT. You refused some of the collateral?

Mr. HOLLAND. Oh, yes, there were some we did not think we would take as collateral.

Mr. ROUSSELOT. You did not take, or you did not think you would? You did not take?

Mr. HOLLAND. There were some we did not take as collateral.

Mr. ROUSSELOT. You did not automatically take everything they offered you as collateral?

Mr. HOLLAND. I guess that the candid description, Congressman, is we looked; we reviewed it with them; we were saying, this will meet our standards, that will not, this will not; it was that kind of process.

Mr. ROUSSELOT. How long did that review process go on prior to accepting what you finally accepted as collateral?

Mr. HOLLAND. Actually, it was a continuing kind of process. It did not take us many days to figure out this loan was going to keep growing, so what we did was trying to keep ahead of ourselves in doing collateral evaluation.

Mr. ROUSSELOT. Over a period of time?

Mr. HOLLAND. Yes.

Mr. ROUSSELOT. Could you provide for us what the par value was of the collateral?

Mr. HOLLAND. Yes.

Mr. ROUSSELOT. Second, the market value.

Mr. HOLLAND. The par value——

Mr. ROUSSELOT. I assume you obviously looked at the market value as well as par value at the time you accepted the collateral?

Mr. HOLLAND. We did for the ones that had a good market. A lot of what we were taking as collateral did not have a good market. I can tell you right offhand the total face value of the stuff we had as collateral at the end was close to $2.5 billion.

Mr. ROUSSELOT. I understand it was $2.2 billion.

Mr. HOLLAND. At one stage it was $2.2 billion; then our loan got close to $2 billion; and we were concerned with further loans. We would not give 100 cents on a dollar on that because a lot of the collateral was not of good enough quality. The loan value of the collateral, which is a matter of judgment, was closer to the $2 billion level.

[The following information was subsequently submitted for the record by Governor Holland:]

The maximum amount of collateral at face value held for Franklin was $2,321.7 million on August 29, 1974. The Federal Reserve Bank of New York determined the loan value of this collateral to be $1,931.4 million after deducting from the face amount margins reflecting the risks of the ultimate collectability of the various assets, as well as reflecting certain other factors. While we cannot determine the market value of this collateral as of August 29, 1974, in our opinion, the realizable value should have been sufficient to cover $1,470 million of Reserve Bank advances outstanding on that date and $226.4 million in secured Federal funds purchases for an aggregate of $1,696.4 million.

The largest advance secured by collateral held for Franklin was $1,767 million on October 2. The face value of the collateral securing the loan on that date was $2,274.5 million and the loan value was determined to be $1,854.4 million.

Mr. ROUSSELOT. Did the holders of large CD's get a chance to basically bail themselves out in the 6- to 8-month period prior to the time that the FDIC took over? Did they have enough feeling and understanding that things were in deep trouble so they could bail themselves out?

Mr. HOLLAND. Franklin's troubles were in the news enough that anyone who was paying much atention to the daily newspapers knew they were in difficulty. I think it was not that the holders of the CD's

had a lot more knowledge than other people. They were more activated by the knowledge. They gradually withdrew as the CD's matured.

Mr. ROUSSELOT. During that 6- to 8-month period, whatever it was, prior to the time that the FDIC took over, what was the total amount of CD's that were cashed in, do you know?

Mr. HOLLAND. Yes; I would guess at that number, I believe it was close to three-quarters of a billion dollars. I will check it and give you an exact figure for the record.

Mr. ROUSSELOT. My recollection was it was almost $1 billion. Your recollection is three-quarters.

Mr. HOLLAND. There was also some foreign money.

Mr. ROUSSELOT. The next question is going to be were most of these domestic corporations, the holders of these CD's, or were most of them foreign? What percentage? Would you give us that information in writing?

Mr. HOLLAND. All right. I will be glad to supply you that kind of information. There is a limit on how much we know about the resident address of the holder.

Mr. ROUSSELOT. Of the CD's?

Mr. HOLLAND. The CD's.

[The information is contained in the Fed's response to the subcommittee dated September 8, 1975, and may be found in appendix A.]

Mr. ROUSSELOT. You certainly know whether they are domestic corporations.

Mr. HOLLAND. We know if they result from the Franklin head office here or the London office, for example. It is a little harder to sort out whether it was a domestic or international corporation. That has to depend on the address and whether or not the document was negotiated. Whether or not the office it was bought through was the home office. Whether it was a New York subsidiary of a large British firm. It becomes very hard to sort out.

[The following information was subsequently submitted for the record by Governor Holland:]

All Franklin's CD's were issued by its domestic branches. It is not possible to ascertain at this time what portion of the CD's were held by foreign entities. It should be noted that a substantial amount of these CD's were in negotiable form and therefore transferable. Franklin's foreign branches issued time deposits or "placements" which are similar in nature to CD's in that both bear a specified rate of interest and have a specific maturity date. The Federal Reserve Bank of New York estimated that one-half of Franklin's foreign branch time deposits were held by foreign branches of U.S. banks.

On May 8, Franklin had outstanding $680.2 million of CD's and $882.7 million of foreign branch time deposits. By October 8, such CD's had been reduced by $489.1 million to a level of $191.1 million outstanding, and the foreign branch time deposits had been reduced by $661.1 million to $221.6 million. The combined decline in both types of liabilities was $1,150.2 million.

Mr. ROUSSELOT. I imagine as people who have to be conscious of reliable, quality items you became very conscious through your examiners, that an awful lot of people were cashing in large CD's?

Mr. HOLLAND. We were working the asset side of the balance sheet rather than liability side of the balance sheet. Our investigation was into the quality of the assets and how long they would last, rather than trying to identify people who were trying to pull money out. The Comptroller may be able to give you more of a feel for that than I can when he testifies tomorrow.

Mr. ROUSSELOT. I am sure we will ask him those questions, obviously. We wanted your judgment on it. Is it possible that the receivership should have been put in place sooner?

Mr. HOLLAND. Well, hindsight always helps a little bit.

Mr. ROUSSELOT. I know that.

Mr. HOLLAND. I would say that I think it was important for us to try to exhaust every reasonable possibility of keeping Franklin going as an independent bank.

Mr. ROUSSELOT. A lot of people feel that by keeping it going you were not only postponing the true day of reckoning; in fact, you allowed people with CD's and things to bail out rather quickly and not suffer the same consequences as others who did not.

Mr. HOLLAND. At the moment even the depositors who stuck with it to the bitter end did not suffer any more than the CD holders who got out early. That is on the deposit side of the relationship. No depositor was injured by sticking with Franklin. If he stayed to the end, he found out the next Monday that he was a depositor of European American Bank. While he may have some feeling about doing different business with a differently named organization, he still had his money. The depositors did not suffer by staying instead of bailing out. Some other people may have; people who relied on Franklin to provide them loans may find it harder to get loans from European-American than Franklin.

Mr. ROUSSELOT. Were there many CD's that were Sindona related?

Mr. HOLLAND. I do not know of any to my knowledge. Again, I will turn that back to the Comptroller.

Mr. ROUSSELOT. If you would be kind enough to answer that.

Mr. HOLLAND. Yes; I will.

Mr. ROUSSELOT. Why was it necessary for the Federal Reserve bank to give up its collateral?

Mr. HOLLAND. Because the assuming bank, in this case European-American, was taking over the deposits, also was willing to take over a large part of the assets of Franklin. The more assets it took over along with those deposits, the less money the FDIC had to put into the operation. It was in our interest, the FDIC's interest, for European-American to take over as many assets of Franklin as it would along with its assumption of deposit liabilities. We had a lien on the collateral behind the $1.7 billion loan. A lot of the assets we had a lien on European-American was willing and able to take for itself. Therefore, by turning those assets over through the FDIC to European American, we allowed the FDIC to put less money into the operation. We allowed European-American to continue to service the borrowers on those notes with an ongoing banking relationship whereas we would have had to do just a straight liquidating job. We could not be a bank for any of those debtors. We had some of the best assets in Franklin by the time it went insolvent. Those were the ones that European-American both wanted and was willing to take.

Mr. ROUSSELOT. On page 3 of your statement you said Franklin, "merited the privilege of accommodation at our discount window so long as it remained solvent. We were advised by its primary bank supervisor that such was the case."

Was any independent judgment made on the bank's solvency between May 8 and October 8, 1974, to make sure the Franklin really qualified for discount window privileges?

Mr. HOLLAND. We were in close touch with the Comptroller. We knew his view from time to time on the state of their solvency. We did not make a judgment independent of his as to whether or not Franklin was solvent. That is our standard practice. We believe it is the responsibility of the primary bank supervisor to decide when a bank passes from solvency to insolvency.

Mr. ROUSSELOT. You did not give him any judgment despite the fact that you saw problems occurring? I thought that you said that you did see problems?

Mr. HOLLAND. We would say we see some problems coming.

Mr. ROUSSELOT. Between May 8 and October 8?

Mr. HOLLAND. We would defer to his judgment.

Mr. ROUSSELOT. He makes the final decision. You are saying it is basically their responsibility.

Mr. HOLLAND. Yes.

Mr. ROUSSELOT. You are still giving him input.

Mr. HOLLAND. If we have any to give. In those places where we had any.

Mr. ROUSSELOT. What I want to know is how much input you were giving them.

Mr. HOLLAND. During that interim period we gave him this kind of input. When our credit analyst went over the collateral, we told his examiners what we thought of the quality of that collateral. That helped them have a check on how their examiners had valved the collateral. I assume that that information was there for him to draw on as he made a decision on insolvency.

Mr. ROUSSELOT. Was that done verbally or in memorandum form?

Mr. HOLLAND. I suppose it was probably done by showing them worksheets. I could check to see.

Mr. ROUSSELOT. If you would let us know on that, we would like to see some of those worksheets.

Mr. HOLLAND. I hope you would not want to see the individual loan numbers and so on, but rather the sense of what we conveyed.

Mr. ROUSSELOT. The sense. Thank you.

[The information is contained in the Fed's response to the subcommittee dated September 8, 1975, and may be found in appendix A.]

Mr. ST GERMAIN. Governor Holland, is it not factual that as a result of legal lending limits, only larger banks can act as managers when syndicating loans as a practical matter?

Mr. HOLLAND. There are some small syndicates. Most syndicates are large enough that it takes a large bank to manage it.

Mr. ST GERMAIN. As a matter of fact, the smaller banks can only get into international loans as participants and they do not earn the rather substantial fees that the large banks get; do they?

Mr. HOLLAND. If you mean the big international syndicated loans; that is true.

Mr. ST GERMAIN. Does this have any implications as far as concentration of banking is concerned?

Mr. HOLLAND. Yes. As a matter of fact, it has led the Federal Reserve to make some regulatory supervisory decisions to try to open up the international business for medium sized regional banks.

Mr. ST GERMAIN. For the record, would you supply those recommendations?

Mr. HOLLAND. We have approved a number of medium-sized banks going together to establish a corporation. We have approved what we call Nassau branches, low-cost windows to the foreign area for small banks.

Mr. ST GERMAIN. This has been going on for a period of time?

Mr. HOLLAND. Oh, yes. I am trying to characterize this as a kind of philosophy of ours.

Mr. ST GERMAIN. In spite of that, it has not been too effective.

Mr. HOLLAND. There is a fair amount of money there. I would not want to argue that it has dealt with the whole problem of the concentration of resources internationally.

Mr. ST GERMAIN. What requirements do the supervisory agencies have as far as the information that is provided to the participating banks, the smaller banks that do take part in these international loans?

Mr. HOLLAND. When an examiner sees the participation document in a small bank, he expects to see the credit information that will let him make a judgement on that loan. If it is not there he criticizes the bank.

Mr. ST GERMAIN. Criticizing the correspondent, the small bank?

Mr. HOLLAND. That is right. That is the responsible banks, the one who agreed to buy the participation. He is the one who is subject to criticism, if he does not have enough credit information to make a reasonable credit judgment. He, in turn, of course, presumably will get on the phone to his city correspondent, and say you have to give me some more information.

Mr. ST GERMAIN. Is it your experience in the ordinary course of business that the information provided to these participant banks, these smaller banks, has been ample and sufficient to allow the participant bank to independently make a judgment on this large international syndicated loan?

Mr. HOLLAND. That is another area where the situations vary. My own impression is it has been skimpy enough to be troublesome. That is one of the reasons our examiners are criticizing the contents of those credit files. I believe this is also an area, Mr. Chairman, where there has been an improvement in practices as a result of the painful experiences of the last year or two.

Mr. ST GERMAIN. Does the managing bank in some instances indicate the fact that it might be anxious to protect the interest of its own branch or a subsidiary in a foreign country by arranging a loan to a Government agency or a favored industry in that country?

Mr. HOLLAND. I do not know of any occasion like that. It may be my lack of awareness of it.

Mr. ST GERMAIN. It has come to our attention that this does occasionally happen, that a syndicated loan is arranged in order to protect or to salvage a branch in a foreign country.

Mr. HOLLAND. I am not aware of the extent to which that is known or unknown by the other banks who are participating in the credit.

Mr. ST GERMAIN. Do you feel that each participating bank should make its own independent analysis of the creditworthiness of the borrower in the syndicated loan?

Mr. HOLLAND. I think it should know enough to make a decent credit judgment on whether it is willing to lend its money.

It is very common in this country, with respect to domestic loans to large firms, to rely preponderantly on the credit analysis performed by what is called the lead bank in a collection of banks that may be lending to a major American corporation. I do not believe that excuses the banks down the line from getting enough credit information to satisfy themselves that it is a sound proposition. Those who have done nothing but ride on the coattails of the city correspondent banks have been pinched a few times in the last few years. That practice is rapidly fading. I think it is a good thing it is fading.

Mr. ST GERMAIN. Incidentally, have you seen the poll recently completed—I think it was commissioned by the American Bankers Association—to determine what the consumer confidence was in banking today?

Mr. HOLLAND. I saw a press story on it. I glanced through it.

Mr. ST GERMAIN. Were you impressed by the same feature or result as I? That being that the bankers thought less of themselves than did the general public.

Mr. HOLLAND. Or the bankers estimated that the public would not think as well of them as they actually did.

Mr. ST GERMAIN. The bankers felt that one of the problems that would be found in the poll was that the general public had a lack of confidence in the type of management there was in banks.

I am wondering which result we should look at, since the bankers themselves thought that management was not all that good. In fact, their percentage, the percentages there indicated that bankers thought less of bank management by a much greater degree than did the general public.

Mr. HOLLAND. I was only a casual reader of it, I should not say.

Mr. ST GERMAIN. I would commend it to your bedside reading, sir.

Mr. HOLLAND. My comment was that I understood the question to the bankers was: What do you think the public thinks of you, or your management, not what do you think of your management? What do you think the public thinks of bank management?

Mr. ST GERMAIN. That is right. By the same token, the bankers, when they were answering the question, were probably engaging in a little self-examination.

Mr. HOLLAND. There may be a bit of that, Mr. Chairman.

I think a number of bankers, good ones as well as ones who have been a little bit extended, have felt that these difficulties that have arisen recently have given them a bit of a black eye.

Mr. ST GERMAIN. I will ask this question quickly.

Mr. ROUSSELOT. I wonder if I could comment in passing?

The same surveys do not show us up too well in Congress, either.

Mr. ST GERMAIN. We did not commission them.

On page 12 of your statement, you refer to a greater than usual concentration of examiner time and attention being devoted to identify problem banks.

How does this differ from prior practice with respect to problem banks? Just in the amount of time, or the number of examiners involved?

Mr. HOLLAND. How frequently they may go back to a problem bank; how assiduously they may press the management; how often they take the time to go 150 miles and sit down with the board of directors.

Mr. ST GERMAIN. What effect does this have on the nonproblem banks? Does this reduce the number of examinations on nonproblem banks not identified as problem banks?

Mr. HOLLAND. We told our hardworking examiners to try to do both. If they did not have the time to do both, at least for an interlude in here, we would rather have them not get quite back so often to a bank that has had a good record and has not been criticized and spend a little more time on the problem banks to be sure they get straightened out.

Mr. ST GERMAIN. Many bankers tell me that they welcome the examinations.

Mr. HOLLAND. I hear that, too, and I take it as a compliment.

Mr. ST GERMAIN. I am wondering if that is the case.

Has any thought been given—this is a very basic thing—to increasing the staff of examiners?

Mr. HOLLAND. Yes. We approved a substantial increase in our examination staff last winter to help offset the increased workload.

Mr. ST GERMAIN. Governor Holland, I want to thank you for your appearance to date. It is after 1 p.m.; we do have a vote on. I am told you have your very delightful family here with you today, and I think it is fabulous that they have been able to take the time to join you. Therefore, I think it is only right—ordinarily I would give you 15 minutes for lunch, which would be giving myself the same—but I think it is only right that you spend at least 59 minutes with them.

We will reconvene at 2 o'clock.

Mr. HOLLAND. My family and I thank you, Mr. Chairman.

Mr. ST GERMAIN. The subcommittee will be in recess until 2 o'clock.

[Whereupon, at 1 p.m., the subcommittee recessed, to reconvene at 2 p.m. the same day.]

AFTERNOON SESSION

Mr. ST GERMAIN. The subcommittee will come to order.

Governor, getting back to the period of time during which funds were provided through the discount window to Franklin National, I must admit I was in error. Franklin National, as a matter of fact, was not operating in the Federal funds market. However, prior to the money coming from the Fed from the discount window, they were borrowing funds from the Federal funds market at 13, 13.5, 14 percent. Once they began getting money from the discount window, that lowered their cost to approximately 6 percent.

Now, assets were pledged as collateral against the advances from the discount window; is that correct?

Mr. HOLLAND. Yes.

Mr. ST GERMAIN. During this period of time when some of these loans that were pledged as collateral matured, and the funds were repaid, were they then re-lent, re-loaned, by Franklin to other prime borrowers?

Mr. HOLLAND. I believe an answer that is almost universally true is no. Almost exclusively, the funds that we were lending Franklin were to fill up a reserve deficiency in their assets—that is, in their reserve deposits in the Federal Reserve—that had been caused by withdrawals, day to day, of large deposits and Franklin's inability to obtain Federal funds from lenders that you are speaking of—that is, other banks.

Mr. ST GERMAIN. In other words, those loans that were repaid that were being held as collateral by the Fed for the borrowings at the discount window were not lent out again? There were no new loans by Franklin?

Mr. HOLLAND. Franklin was making a few new loans; they were few and far between. Most of them were when they were under commitment to make them; they had outstanding lines of credit or commitments they had to honor. I believe, also, some part of their consumer credit operation continued. For the most part, they were trying to squeeze down their loan totals all the time they were in our debt.

I might say one other thing. I think—I had a chance to check the records over lunch—I think the interest rate discrepancies were not quite as big as the numbers we were using for illustration this morning. The Federal funds rate, while they were in the market, was climbing, but not up at 11, 12, 13, 14 percent for banks in general. Franklin, however, was being charged a higher rate than some other banks, as other banks lending to it began to get a little uneasy about its status. Finally, they just stopped lending. It was after they stopped lending that we came in. A small group of New York City banks came back in and loaned them Federal funds on a secured basis through the summer. Most Federal funds loans are unsecured. That kind of unsecured lending to Franklin just dried up as confidence faded away.

Our loans to Franklin were typically at 8.5 percent. That was the discount rate during most of that interval, except until the very end when we created the new emergency rate and we were charging them 10 percent.

Mr. ST GERMAIN. The examination report of March 1972 to May 1972, contained a volume of criticized loans then of 74 percent of gross capital funds, plus notations by bank examiners—I quote: "An intolerably high volume of loans subject to adverse comments. Suggest strong corrective measures."

Then, the examination of November 1973 to March 1974, volume of critized loans, contain 111 percent of gross capital funds. Notation by the examiner: "Alarming."

The examination was resumed May 8, 1974.

Now, in this period of time, from March 6, 1972, to March 1974, there was a decrease from $3 billion to $1.2 billion in CD's.

That seems unusual to me. Would this indicate that there were some people on the outside who got word of the fact that that March 1972 report was not too favorable?

Mr. HOLLAND. That sounds a little large to me as the decline for that time interval. I would have to check my own records to be sure.

Mr. ST GERMAIN. Staff states that those are the figures.

Mr. HOLLAND. By May?

Mr. ST GERMAIN. March 6, 1972, $3 billion; March 1974, $1.8 billion—a decrease of $1.8 billion in CD's.

Mr. HOLLAND. I would not have recalled the number as being that large.

Mr. ST GERMAIN. Perhaps you could check it out.

[The following information was subsequently submitted for the record by Governor Holland:]

The weekly Report of Condition for Franklin National Bank submitted as of March 8, 1972 shows total CD's in denominations of $100,000 or more of $295 million. By contrast, large CD's outstanding as of March 28, 1973 and March 27, 1974 were $521 million and $464 million, respectively. Unfortunately, this weekly report does not include CD's issued by Franklin's London Branch. However, call report data for April 18, 1972 show Franklin's total time and savings accounts to be $1,112 million as compared with $1,317 million on April 28, 1973, and $1,313 million on April 24, 1974.

Mr. HOLLAND. I would like to comment on the general substance of what you say.

One cannot deny the possibility that examiners' reports get known about. We try, and usually the banks try, to hold them very confidential and very closed, for obvious reasons. Oftentimes there are critical remarks in there. It is true that examination report would have been shown to all members of the board of directors of Franklin National.

Franklin National's board of directors had its differences. In those days there may have been some tensions and discussions that ranged a little wider than they would in more tranquil times.

I did not hear a lot of talk about Franklin National's bad examination reports during that interval. I can tell you——

Mr. ST GERMAIN. Did you hear about the bad examination report in 1972?

Mr. HOLLAND. Through our internal operations, not through public sources.

There was, however, a gradually rising level of commentary among people in the New York and Long Island business and banking communities.

Some of the dissensions showed as the management and the directors changed. There was a gradually rising tide of criticism spreading that may itself have triggered some outflows.

Mr. ST GERMAIN. Would you be aware of the fact that shortly before the Fed opened its discount window to Franklin in May 1974, that there were discussions between Franklin National and Manufacturers Hanover Trust considering a merger of the two banks?

Mr. HOLLAND. I was aware of that.

Mr. ST GERMAIN. Did a press release go out to that effect?

Mr. HOLLAND. Not to my knowledge. They may have said something.

Mr. ST GERMAIN. Had the Fed given any indication that they would speak to Justice about this, as far as the antitrust implications were concerned?

Mr. HOLLAND. Not to them; no. We, in problem cases—and this was true a little later on in Franklin's episode——

Mr. ST GERMAIN. We are talking about May 1974, when there were discussions and an indication by Manufacturers Hanover that they were prepared to take over.

Mr. HOLLAND. To my knowledge, we did not say anything to Justice at that time. I can check to be sure. I believe the Comptroller may have. At that time, we were beginning to be concerned about acquisitions,

and a purchase by Manufacturers Hanover, being as large a bank as it was in New York City, would raise obvious competitive questions, so that I believe there were undoubtedly discussions that took place about the need to discuss this matter with Justice. To my knowledge, we were not a part of that until it came up a little later.

Mr. ST GERMAIN. All right.

During the week of May 6, progress was made on at least two of the three issues raised by McGillicuddy—one being an antitrust clearance and another of not bringing Franklin's top executives into Manufacturers. In addition, McGillicuddy had a record of earnings growth that he cherished. If he took on Franklin's losses, the record would be tarnished. So some form of subsidy from the FDIC would be required.

I was told that the negotiations were going on very nicely. You are right, the Fed was not involved in this request to go to Justice. It was Mr. Sindona who opposed the merger for obvious reasons—was Mr. Sindona the individual who called in the New York Fed for assistance in May 1974?

Mr. HOLLAND. No. I believe that phone call, at least the key phone call at that time came from Mr. Gleason, although we were at that time communicating with several levels of officials.

Mr. ST GERMAIN. In May 1974, when that call came through, was the Fed aware of the fact that these discussions with Manufacturers Hanover had been taking place, and that there was serious interest by Manufacturers Hanover?

Mr. HOLLAND. We were aware of the discussions. We were aware of the interest. How serious that interest was, was a matter of some uncertainty in our minds.

Mr. ST GERMAIN. Did the Fed discuss it with Manufacturers Hanover at that point? Prior to going into this discount operation, which eventually increased the $1.7 billion?

Mr. HOLLAND. It is best to think of those two actions as independent. The discount window accommodation we would have provided whether or not Manufacturers Hanover was in the picture. The discussions of Manufacturers Hanover with Federal Reserve people would be because we might have had to approve that action.

Mr. ST GERMAIN. Mr. Wylie.

Mr. WYLIE. Thank you, Mr. Chairman.

On page 10, you say, "The Comptroller and FDIC respectively, with their own statutory obligations, have had to effectively exhaust alternative solutions."

Was there any conflict between the Comptroller and the FDIC? Or what alternative solutions are you talking about there?

Mr. HOLLAND. The alternative solutions, short of receivership, was primarily the job of the Comptroller to look into and exhaust. He kept both us and the FDIC apprised. He, as the primary supervisor, was responsible for doing anything that could be done to save the bank, short of receivership. He talked to some other banks earlier in the spring about the possibility of their merging voluntarily. As that did not turn out well, he talked to some international banks and he talked to the FDIC about the kind of assistance they might be able to provide if it had to go all the way into receivership.

Meantime, the Franklin National leadership itself was trying to propose one and another changes that might have made it possible to save

the bank. There was an early proposal to put in a little capital help, but it was not nearly enough. There was a proposal developed later in the summer that involved some massive FDIC assistance to the Franklin to keep it open as an independent institution. That one, the FDIC did respond to negatively shortly before the bank was ruled insolvent. That was the last effort in the endeavor to keep it independent. When that proposition was judged so conclusively by all parties who looked at it as one that simply would not fly, we then had to face the hard alternative that the Comptroller was looking at an insolvency determination.

Mr. WYLIE. When you refer to the Franklin Bank leadership, to whom do you refer?

Mr. HOLLAND. For the most part, Gleason, although there were other men who were involved, particularly a man brought in from outside, given operating responsibility for trying to shake it together. His name escapes me at the moment. I talked to him many times during this interlude. A fine gentleman trying to rescue the bank. Later on, of course, Joe Barr, came in as chief executive to try to pull the organization through.

Mr. ST GERMAIN. Will the gentleman yield?

Mr. WYLIE. Yes.

Mr. ST GERMAIN. Do you include among these a chap named Sindona, also? Was he included?

Mr. HOLLAND. No; he was not a part of the operating management of the bank as we saw it and as we were dealing with it.

Mr. WYLIE. At the bottom of page 10, you say, "As nearly as can be judged"——

Mr. HOLLAND. I am sorry. As far as we were concerned, he was not involved. I think he talked to the Comptroller in terms of capital injections, in terms of ability to run the bank—the Comptroller can tell you better than I—about the possibility of keeping it independent instead of merging.

Mr. WYLIE. Also at the bottom of page 10, you say "As nearly as can be judged at this stage, not a cent of depositors' or taxpayers' money is expected to be lost in the process."

What happened to the $1.7 billion which was referred to the hearings last December as having been felt as a loss?

Mr. HOLLAND. That is not a loss. That was the size of our loan to Franklin. We had collateral behind it. When Franklin was taken over, put in receivership and folded into European-American, the FDIC assumed that liability.

Mr. WYLIE. That money was advanced to them in the form of a loan?

Mr. HOLLAND. In the form of a loan.

We expected and we still do expect to be repaid. The FDIC agreed to repay us in place of Franklin in exchange for us releasing our lien on the collateral we held behind that loan. They, in turn, turned that collateral over, such of it as European-American wished, to the European-American bank as a part of the ongoing institution. We expect to get paid back completely.

Mr. WYLIE. From the look of these hearings from last November and December, we are, I think, going over a lot of plowed ground, except, I suppose, we are going into this question as a kind of update to see if

there is anything additional we should know in the way of information so that we can formulate appropriate legislation.

During the hearings in December, I suggested that there were three different organizations involved in the San Diego National Bank operation and the Franklin National Bank operation: The FDIC, the Comptroller General and the Federal Reserve. And that there ought to be some sort of coordinating committee operation or some sort of an arrangement whereby one person would oversee the collating of information and distribution of information so that the three agencies would be communicating with each other. And you responded, and I could not find it in the hearings at the time, rather affirmatively about that.

Do you have an additional thought on that now?

Mr. HOLLAND. I said I thought close coordination and communication was the key to a successful carrying through of these processes. In my opinion, we had fairly close coordination and cooperation during that period. Hindsight tells us there were sometimes when more time elapsed between when one person spoke to another person in one of the other agencies than was desirable, and there were times when we had different views we had to work out together. On balance, I would say we had reasonably good coordination. We had enough to bring it off. I did not mean to be advocating a new cleanup organization, although you will find later on in my testimony today, I am speaking about some organizational changes to focus on standards in this area which I think might be helpful.

Mr. WYLIE. I see.

Mr. HOLLAND. The way this works, there is a lead agency among the three. Until a bank is insolvent—in this case, the Franklin—the Comptroller, as its supervisor, was the lead agency; he had the final say-so as to whether it was solvent or insolvent. The rest of us, while we spoke very frankly and candidly on frequent occasions, recognized that he had the final word. Once it was in receivership, the FDIC was the lead organization.

Mr. WYLIE. We appreciate your testimony and answering questions. Perhaps now we should ask whether there is any question we have not asked that would help us reform bank regulation procedures.

Mr. ST GERMAIN. The subcommittee will be in recess for 12 minutes while we go vote, and we will come back and ask those questions.

[After recess.]

Mr. ST GERMAIN. The subcommittee will come to order. Governor Holland, you said in your response to Mr. Wylie, that the Comptroller declared Franklin insolvent. Is that declaration of insolvency in reality a fictional thing? In other words, that declaration is made within minutes before the merger is effected. Is that not a fact? In other words, in May 1974 when conversations were being held with Manufacturers Hanover, at that point in time could not Franklin then have been declared insolvent?

Mr. HOLLAND. I was not the Comptroller, so I did not have to make that decision. I believe some of the factors to be weighed in that decision of insolvency would not have weighed as heavily in the spring. It was not as clear how much liquidity would run out of the Franklin as a result of the pressures. It was not clear as to the losses we would uncover in their assets. It was unclear as to the ability to generate

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capital additions to keeping it going as an independent institution.

Mr. ST GERMAIN. It had been on a downhill course for 2 years, from March 1972 until that examination in March 1974. Then another examination was begun in May. Within a matter of weeks——

Mr. HOLLAND. Oh, yes; they were trying to check on it very closely. Still and all the facts turned up did not have as much weight on the insolvency side as the facts that came to light by the end of the summer. The declaration of insolvency is oftentimes a matter of judgment.

Mr. ST GERMAIN. It was not made in May; it was made in October. There was an attempt to salvage it. You pumped money through the discount window, you were just propping it up, were you not, until such time that a decision could be made as to what was the best way to handle it?

Mr. HOLLAND. We thought it was still solvent. We were still operating under the advice that it was solvent through the summer; as we were commenting this morning, it would have been better for the competitive atmosphere in New York if we could have preserved Franklin as an independent competitor. That was partly why strenuous efforts were made to see if something could not be done to put in new management, put in new people, to see what they could do.

Joe Barr as the new chief executive, made his last pitch to keep it going as an independent bank in August or September.

Mr. ST GERMAIN. However, you were holding the $1.7 billion in collateral.

Mr. HOLLAND. More than that on face value. Our collateral arrangements with Franklin let them draw it out if it was not needed to back their loan or to replace it with other collateral when they needed to do so to operate as an ongoing business institution. We did not have it locked up in a room where it could not be used in the banking business.

Mr. ST GERMAIN. Did the Fed ever determine whether or not Mr. Sindona had any relationship with the European American Bank & Trust Co., or any of its parents, the Deutsche Bank, Societe Generale, Midland Bank Group, Societe Generale de Banque, Belgium, Amsterdam-Rotterdam, and the Creditanstalt-Bankverein, Austria?

Mr. HOLLAND. To my knowledge—and there may be things I do not know—to my knowledge, no tie in the sense of stock ownership or that kind of thing existed. Those are big banks. They surely must have handled some business deposits, loans, money transfers or something with the Sindona banks, as active as some of those Sindona operations were in Europe, but not to my knowledge a network of affiliates or common controls.

Mr. ST GERMAIN. To your knowledge, was a thorough search made to determine whether or not in fact Mr. Sindona, or any of his bank family, were dealing with any of these six major banks that took over Franklin National through the medium of the European-American Bank & Trust?

Mr. HOLLAND. If you mean ordinary transactions——

Mr. ST GERMAIN. Substantial loans, outstanding, and so forth.

Mr. HOLLAND. I do not know whether a check was made to see that nothing like that happened.

Mr. ST GERMAIN. Getting back to what we were talking about this morning, here we have in reality six banks that took over Franklin

National through the European-American. The initial discussions about a takeover were in May. Final takeover or merger was in October 1974. Do you not feel that there could have been efforts extended to get together a group of smaller banks, rather than one big bank in New York City to divide up the assets and liabilities of Franklin National?

Mr. HOLLAND. I will let Jim Smith tell you that in more detail tomorrow. We did experiment with the idea of breaking Franklin up into two or three pieces to see if it would be more salable, or really, if that would make it more digestible by a somewhat smaller institution than the giants. Sawing up the institution just did not turn out to be a workable way of putting it back into the banking business.

You must understand, Mr. Chairman, that part of what one was dealing with at that time was how the other bank managements felt about the proposition. There can be times when a banker who might be the head of a bank big enough to handle something like that would say, "I do not want to touch it." He has his own business reasons for not wanting to touch it. He says:

> I want to work in my own shop. I do not want to take on the headache. I am busy enough working along with the kind of market growth and profit performance that I understand and can control. I just do not want to take it on.

Mr. ST GERMAIN. Are the supervisory agencies giving any thought—actually, this question should probably come after the next part of your presentation, but since we were on this topic, to developing a modus operandi, saying that the interstate portion of the bank holding company amendments that are before us were not to fly too high? Have you been giving any consideration to an alternate solution? In other words, if there was a situation where we have a large bank about to fail or in jeopardy, then it would be possible to gather together a group of banks to determine if they could form a consortium to divide the thing up?

Mr. HOLLAND. We have thought about it in two ways. One is such a consortium type of arrangement. We have talked about it a bit among ourselves, I mean, among our staff and members of the Board occasionally; and some with the other agencies. We concluded that consortium, particularly one that is brought into being for that kind of a rescue operation would be poorly equipped and poorly organized to handle it. They would come in without much background of working together and then try to take over the pieces and make a going institution out of one which is already full of problems, or you would not be trying to place it with somebody else. It starts out with two strikes against it. Then, in addition, there is the negative factor, that you would be encouraging competitors in an area to get together in order to try to organize——

Mr. ST GERMAIN. My thought was to get together to divide up, not that they would end up in a merger. Let us look at Crocker National takeover of U.S. National of San Diego. What a heck of a deal. That was fantastic for Crocker. Look at the branches they picked up. How long would it have taken them to find those branches, and how long would the ordinary application process have taken if they had attempted to establish branches in these areas? In one fell swoop, how many branches did they pick up?

Mr. HOLLAND. I understand what you are saying.

Mr. ST GERMAIN. What I am talking about, as opposed to what happened with Crocker, is understandable as far as the takeover of U.S. National is concerned. In the case of Franklin, European-American, controlled by six very large foreign banks, took over Franklin National. If it was a modus operandi whereby you get together a group of small banks to form a consortium to acquire a large bank, was any consideration given to a similar approach in the case of U.S. National? U.S. National operated in x number of communities in California. Were there medium-sized banks, in these areas of the State that could have taken over proportionate shares of the assets and liabilities of those branches? There would have been an incentive there.

Mr. HOLLAND. I would not expect that possibility to be ruled out even if we had the other legislation.

Mr. ST GERMAIN. Maybe the other legislation would be looked at a little sooner if it were to come to our attention that some method of working out that type of situation had been sort of worked out.

Mr. HOLLAND. It has been looked at. I do not want to sound optimistic about how workable it may be. I could imagine a case or two where it would work. Conceptually, Franklin might have been a situation where it would work. There are Long Island branches, the London operation, the downtown Manhattan operation. One could look at it and envision a splitting into three pieces. We did look at it from that point of view. It turned out that we could not find an attractive package that we could interest other people in. They did not seem to be as attracted as we thought they would be to acquiring pieces of the bank's operations. Then there was the practical business difficulty that what interest there was tended to center on the most attractive part of Franklin, the Long Island branches. That would have left the FDIC or whoever took over the rest of the bank with still greater problems than before in the two remaining parts of the organization. There was nobody who was willing to buy those. It looked like the only way we could get the whole thing taken care of was to insist that it be sold as a whole.

This kind of handicap on the divided approach was one of the reasons that we came forward with this multistate proposal. We began to realize that there were occasions when you cannot break it up. I should not say cannot, but where it is not practical to break it up, or it will cost the FDIC a lot of money if we do.

Mr. ST GERMAIN. Because we did not know the cost to FDIC in 8 to 10 years before we knew it—the European-American takeover of Franklin.

Mr. HOLLAND. Frank Wille may be able to give you a better estimate next week.

Mr. ST GERMAIN. If the past is prologue——

Mr. HOLLAND. You will be proven to be a very good estimator with that number.

Mr. ST GERMAIN. When we look at the correspondence between Chairman Burns and Mr. Patman, and when I recall the stories that I read at the time about the acquisition by Fasco International of approximately 21.6 percent of the Franklin New York Corp., the holding company for Franklin, we found that issue was never really resolved

by the Fed, and it sort of was left hanging—perhaps, it should go to the courts. Am I correct in that?

Mr. HOLLAND. We thought we would resolve it when we made some of the decisions relating to the Talcott acquisition, that came up in the winter. We thought that in connection with that acquisition the whole question could be resolved. In the end it did not because of the Board's denial, and we would have had to go back to that issue, had not Franklin come unstuck the way it did.

Mr. ST GERMAIN. As I recall it, the Fed made a determination that Sindona was not in control of Franklin.

Mr. HOLLAND. Rather the negative of that, we never found enough evidence to let us say that he was in control; that is that he did exercise a controlling influence. We did not find conclusive evidence of that.

Mr. ST GERMAIN. Whom did the New York Fed meet with when the determination was made to open the New York discount window to Franklin? Did they meet with the officers and directors of Franklin, or did they meet with Mr. Sindona and his attorneys?

Mr. HOLLAND. Those borrowing decisions, my recollection is, were handled entirely by the officers and management of Franklin. Sindona was not a part of the discount window discussion. He was not a part of the operating management as far as we were concerned.

Mr. ST GERMAIN. Are you familiar with the Fortune magazine article, "What Really Went Wrong With Franklin National?"

Mr. HOLLAND. I remember the story.

Mr. ST GERMAIN. This is an allegation from that particular story.

Mr. HOLLAND. I think it mentioned that Sindona was at a meeting in the Federal Reserve when they were talking about a number of things. That was not the place where the discount window access was established.

Mr. ST GERMAIN. "On Sunday, May 12, Sindona moved to quash the effort"—that was Manufacturers Hanover taking over of Franklin National. "On May 12, Sindona moved to quash the effort and managed to set up a remarkable, high-level meeting of the Federal Reserve in New York. Representing Franklin was Sindona, his lawyer, Randolph Guthrie, of Mudge, Rose & Guthrie"—that is a pretty famous firm, by the way—"Carl Bardoni, a close associate and member of Franklin's board, Harold Gleason, and the bank's PR man, Arthur Purfore.

"Of this group, the only one that could conceivably claim a nodding acquaintance with Franklin's operating problems was Gleason. Sindona excluded from the meeting all the bank's top operating executives. While he brought along his own personal lawyer, he did not invite the bank's longtime law firm. It is little wonder then that the regulatory agencies received a badly garbled account of the bank's situation. What is puzzling is that the regulators accepted this account without too much question."

Mr. HOLLAND. That meeting dealt with the question of a capital injection. Whether or not additional capital would be injected, whether the bank might be sold or merged. The question of access to the discount window was not discussed with Mr. Sindona.

Mr. ST GERMAIN. With the failure of the proposed merger with Manufacturers Hanover, was there any alternative but to go to the discount window?

Mr. HOLLAND. I think the discount window demand was due to develop anyway.

Mr. ST GERMAIN. Once that proposed merger fell through, there was then no alternative, was there?

Mr. HOLLAND. The way the publicity was unfolding about Franklin, they would lose enough resources in credit withdrawals that they would have come to the window to borrow.

Mr. ST GERMAIN. Mr. Moorhead.

Mr. MOORHEAD. I have no questions.

Mr. ST GERMAIN. I think the time has come to get back to that portion of your prepared statement that deals with legislation. I think it runs from page 14 to page 32—and it is a discussion, of the waiver of the 30-day notice requirement, and other legislation that you mentioned earlier this morning, which would allow interstate acquisitions by holding companies under certain restrictions. Legislation has been introduced. Would you have any objection to having that rather copious piece of material that I have read, and I think you have skimmed through it also, in the record? We have already placed this testimony in the record in its entirety, and we could then proceed to question him on that particular portion of his testimony.

Mr. MOORHEAD. I think that is an excellent suggestion, Mr. Chairman. I would have no objection.

Mr. ST GERMAIN. We will save your vocal cords.

Mr. HOLLAND. I believe the first part of that bill, the 30-day time——

Mr. ST GERMAIN. If you would like to make some comments right now, why do you not proceed; then we could proceed to questioning.

Mr. HOLLAND. I will just ad lib a little. Our proposals are really twofold, one getting rid of the statutory time delays in emergency cases; second, to allow multistate holding company acquisitions in emergency cases. As far as I can find out, and I have been talking to a number of people about these propositions for the last few months, there is no controversy over getting rid of the 30-day time delay in an emergency case. All the parties I know who have an interest, both in the Federal Government and the banking system, think it is reasonable. It is just imitating in the holding company act the kind of procedures we have already tried and found helpful in the bank merger act.

It seems to me that that needs no comment, as far as I am concerned. The other proposal is more controversial. I might say I urge the subcommittee if it could, to act on that one, that does allow any within State holding company to be a part of an emergency salvage effort. As of now they are terribly handicapped by agreeing to save something and hoping it lasts 30 days so they can do the saving.

The second proposal is, of course, more controversial. That is the one that would allow in an emergency case, an out-of-State holding company to bid and would allow the Fed as the regulator in this case, to permit them to acquire a failing bank if, in effect, we thought that the other in-State acquisitions were anticompetitive and that such an acquisition would best serve the public interest.

Since you have read the statement, I will say no more about it.

Mr. MOORHEAD. Could I just ask you this? On the second part, is this bill an administration proposal, for example, does it have the endorsement of the Justice Department?

Mr. HOLLAND. The Justice Department favors both provisions of this bill. They think it is procompetitive; insofar it makes them give up some time delay that they have been given under the act, they are willing to give it up. I believe there is a letter filed with the committee in this respect. If not, I will be glad to request that one be filed.

Mr. ST GERMAIN. If I may state, Mr. Moorhead, I was checking with the staff. It seems to me that the subcommittee wrote, and we do not recollect receiving a reply from Justice. We have not received a reply from Justice on the interstate aspect. You say the Federal Reserve Board has received a reply from them?

Mr. HOLLAND. We have talked with them, and they strongly support it.

Mr. ST GERMAIN. Have they given you anything written?

Mr. HOLLAND. I do not remember seeing a letter. I am told that through the Office of Management and Budget they responded supporting this legislation. I am sure they would be glad to address the subcommittee.

Mr. ST GERMAIN. I am zeroing in a little more. What finally came to the subcommittee as a result of a letter from Chairman Patman of one of our other subcommittees. The reply from Justice on that one, very frankly, depending on which side of the proposition you wanted to take, could be used to say that they are for it or that they are against it. You might want to get a new letter from Justice.

Mr. HOLLAND. I think it would be better to do so in that case. I am satisfied myself from our conversations with them, that they regard this as a strongly procompetitive proposal and would be glad to see it enacted. The only thing they asked us is why did you not go further. Our answer was this is as far as our responsibility goes. When I say why did we not go further, that is why did we not propose to let out-of-State banks, not just the bank holding company come in and bid. We said that is a national charter question. We were only addressing this proposed bill to the law we are responsible for, the Bank Holding Company Act.

I can sum up the reasons why we feel we need this bill in three sentences. We fear that somewhere across the country there is going to be a big bank that will get into a lot of trouble. When a big bank, a really big bank, one of the biggest banks in the city or State, gets in trouble, there are only three choices. The regulators have to save it by corrective action if they can. If they cannot, then if it is that big a bank, our only choice in the absence of this legislation is to sell it to a big bank competitor within the State or close it. We think both of those are undesirable alternatives.

In a rare number of cases, it will be distinctly better for the public interest to be able to let that kind of a bank be taken over by a holding company from out-of-State. We think it would be more procompetitive. We believe it will hold down the concentration of banking resources. We believe that both of those results are consistent with the spirit of the banking legislation we are administering.

I would be glad to answer any questions you would like to ask about it.

Mr. ST GERMAIN. Mr. Moorhead.

Mr. ST GERMAIN. Is there, perhaps, a problem that always occurs

Mr. MOORHEAD. One technical question, Mr. Chairman. Under existing law an out-of-State holding company cannot acquire a bank system in another State. Is that correct?

Mr. HOLLAND. That is true. Yes.

Mr. MOORHEAD. You are now proposing to change that?

Mr. HOLLAND. We are proposing to create a special exception, a little window that would make an exception to that standard prohibition when there is no good alternative for anyone else to take over a big bank that is in trouble. Then the Board could consider approving an acquisition by an out-of-State holding company.

Mr. MOORHEAD. That would give you another string to your bow, rather than having to go abroad?

Mr. HOLLAND. Exactly right. That seems to us like going around the barn, to use a phrase from back home. The obvious approach, if you are going to have to go outside the State, is to let the powerful banking institutions elsewhere in this country help and not say it is only a foreign organization that can come in and help.

It is a problem that arises from the structure of our banking system. We have in many of our States a few banks that are much bigger than the rest of the banks in the State. They have developed that way, not for a lot of bad business reasons, but because that is the way competition and history have made them grow. It does mean that if one of those few of the biggest banks in the State gets in trouble then we have difficulty finding a way to save it, unless we are able to fold it into an out-of-State holding company.

Mr. MOORHEAD. Just one more question. We are going to have the Comptroller of the Currency up, I understand, Mr. Chairman. We might want to ask him about this bill, H.R. 4008, and whether it should be as Justice recommended, expanding the holding company acquisition. Could you give the benefit of your advice as to whether I should urge this upon them, or go against it?

Mr. HOLLAND. You should ask him and obtain his judgment. I will be surprised if he does not think it would be a good idea. Some of the same argument I am making here could likewise apply to acquisitions by out-of-State banks. The one substantive reason why we did not ask for it ourselves is that we realized we would be dealing with States in many cases that had State laws and traditions against branching. In those States, the State bank supervisory authorities might find it more compatible with their traditions and usual relationships, if the bank being taken over remained an independent corporation, a part of a bank holding company which is what it would be under our bill as distinct from that bank becoming a branch of a national bank in another State, as it would become if you allowed interstate branching on an emergency basis. Therefore, we believe consideration should be given to the State supervisory interests and traditions in dealing with these problems.

In addition, we had the procedural concern that Federal law permitting out-of-State branching is the Comptroller's business; we ought to let him propose that change if he wishes to do so. But the logic of our position, in terms of out-of-State help, is applicable to emergency out-of-State branches as well as to emergency out-of-State bank holding company acquisitions.

Mr. MOORHEAD. I see. I think there are also some political matters.

Mr. HOLLAND. We would just as soon not stir up any more. We stirred up political concerns with this proposal, we know. I come from a State that is all unit banks. Branch banking is a swear word out there. I believe this proposal is in the best interests of the people in the State I come from because it is better than having one of their big banks suffer one of these two alternative fates, if it should happen to get into trouble. I do not believe this is the camel's nose. I do not see any reason why a holding company should be allowed to expand to a 5-, 10-, or 20-unit interstate complex. I think this authority would be used only on rare occasions, and any bank holding company would get only a very few opportunities over its entire life to make out-of-State acquisitions.

I am not trying to make life easier for the bank holding companies. I am trying to keep big banks operating and helping people in their States.

Mr. MOORHEAD. Thank you, Mr. Chairman.

Mr. ST GERMAIN. Franklin National was talking about a merger in May 1974 and then, of course, they went to October 1974. There is a question as to whether Franklin was insolvent in May or not. Let us say it was halfway insolvent. Could not this particular legislation if it had been law then have received the situation in one fell swoop. There would have been no problem having one of the major bank holding companies from out-of-State say, sure, we would love to pick up Franklin. Fantastic. We will get ourselves branches in the State of New York. Is that not wonderful? As a result thereof, the efforts that were expended, as delineated already to us, and which I am sure will be described to us in further detail in the near future by the Comptroller and the Chairman of the FDIC, would not really have been so extensive. Some of the larger bank holding companies around the country, would have been very happy to come in; is that not a fact?

Mr. HOLLAND. It could have turned out that way.

Mr. ST GERMAIN. It becomes a very easy method of disposing of a large failing bank.

Mr. HOLLAND. The reason I say, could, I grant that is a possibility, but I do not want to sound confident that is what would happen, partly because Franklin had enough troubles so that the number of big banks around the country who thought they could take it on and handle it, might have been pretty small. Second, I would emphasize the spirit of this legislation that we are proposing which would call for us and the primary bank supervisors to work very hard to try to find alternative ways of keeping a bank going, before deciding that the only alternative course that serves the public interest is allowing an out-of-State bank holding company to buy it.

Mr. ST GERMAIN. Now we will get to the spirit. The proposal, in effect, seems to say that if a bank is both very large and failing, it is all right to allow a multistate bank merger.All right?

Mr. HOLLAND. Yes.

Mr. ST GERMAIN. I think we should look at this on a wider basis. No. 1, are there not times when failure in liquidation might be the thing to do? If this were to happen to one of our large banks which got into trouble, would there not be a little bit more responsiveness and

responsibility on the part of the directors and the officers of these banks? I look at the U.S. National and the complete cop-out by the board of directors. They just let Smith run roughshod over them. If they did not like what he was doing, he just dismissed them and appointed somebody else. And look what happened to Smith after what he did to so many people around California and around the country. They tapped him on the wrist and gave him a $30,000 fine. Was that it? A $30,000 fine?

He lived high off the hog for many years off others' money and ruined how many lives, hurt some of the largest, oldest, and most distinguished banks in the country.

If the boards of directors in the offices of these large banks realize that they have to be a little more careful, then perhaps also the examiners and the supervisory agencies should be more thorough in their examinations and oversight of bank activities. I realize they are improving now from the balance of your testimony. I think it is evident that the supervisory agency and the examining process has not kept up with the times. Jim Smith—in a statement of his I read—said examining banks that are completely sophisticated with computerized techniques is difficult since the Comptroller's office itself never had a computer until a few months ago. In other words, my view over a period of time, looking at these failures—and it started with Sharpstown in Texas, and San Francisco and U.S. National, Franklin and Security—that these are the biggest we are talking about. It is always after the event you shut that barn door after all the livestock have escaped.

Is there anyone in the Fed whose function it is and has been to update examination procedures, not as a result of a mistake that was made, but on a constant basis? Is there anyone in the Fed with that responsibility and authority?

Mr. HOLLAND. There is now. We have a committee of four Governors and some of our top examiners working with the committee. They have been spending the last 9 months on this, as part of our overall review of banking.

Mr. ST GERMAIN. Was this triggered by Franklin?

Mr. HOLLAND. Yes. We had been doing a little talking before. After Franklin, we saw that we needed a top-level focus on bank examinations and related problems. That is why we created this four-Governor committee.

Mr. ST GERMAIN. Do you feel that there should be some criminal penalties for bank officers and directors.

Mr. HOLLAND. We believe that there may be places where that has a role to play. However, looking at the failures of the banks we have just talked about here recently, U.S. National, Franklin National, my own guess would be that the things that happened to the management and the stockholders of those two banks in those cases were about as bad as would have happened to them had the bank actually had its door closed and the FDIC liquidated the bank and paid off the depositors. Most of the management is out on the street. The stockholders, I believe, have lost most of their mony. Those were the kinds of business losses suffered.

I do not think that the business losses of the managements and the stockholders would have been much bigger if the bank had actually

been closed and liquidated. They suffered the sort of penalties our economic system visits on people who make the mistakes.

Mr. ST GERMAIN. You said the losses to the stockholders and management. How about depositors?

Mr. HOLLAND. Some of the depositors might have suffered more, if the bank had actually been shut, and FDIC paid out, because FDIC is not allowed to pay out anything above the insurance limit. The deposits that were in the institutions above that limit would have been gone.

Insofar as anybody can say before the fact, I believe the spirit in which the Board recommends this legislation, and I trust the spirit in which the Congress moves forward with it, is that, this is not to be an easy copout. This interstate bank holding company operation is in the nature of a last recourse when we cannot find solutions that will keep the organization going and serving its area within the in-State structure. And I would hope that we would administer it in that spirit. If Congress passes the bill, I hope you will tell us to do so in your committee report.

Mr. ST GERMAIN. I must say I do not know what my colleague, Mr. Moorhead has had, but I have had a great number of people in the industry express concern over the interstate section of the bill.

Mr. HOLLAND. I know the feeling is that this is the camel's nose.

Mr. ST GERMAIN. They feel similar to how the Fed felt about where the credit was going and the credit bugaboo failed on the floor. Your position was, that this was a step in the door.

Mr. HOLLAND. I would say touché on that one. I do not mind Congress closing this door tightly enough so it prevents it being a step in the door. I put in my testimony this suggestion. If you desire, you could amend our draft legislation by saying no bank holding company could get more than somewhere between two and five interstate acquistions. That would effectively prevent a large interstate operation being established through this emergency loophole. Whether you are Bank of America, First National City, Mellon, Continental, or any other large bank holding company, you can only get two or three or four of these emergency acquisitions around the country. That would be enough authority to provide the kind of safety net we are looking for. But it is surely not enough to cause an interstate banking network.

One does have to weigh, on the other side of the fence, I believe, the very real suffering that the failure of a flagship bank in one of our States could produce within that State.

Mr. ST GERMAIN. On page 22 of your statement, you refer to the heightening of the problems of the banks as they move increasingly from asset to liability management. The current issue of Forbes magazine discusses many of the problems that have been created by this. Then on page 23, you state that the shift has been beneficial to customers and communities. Could you explain what you mean by this beneficial aspect?

Mr. HOLLAND. It is a matter of the financial institution being able to obtain funds from outside of its own community, and then lend them in the community where money is in demand on a good credit basis.

Mr. ST GERMAIN. How about a disinvested neighborhood?

Mr. HOLLAND. This would create assets for that disinvested neighborhood. That is right, as I see it, Mr. Chairman. The increasing sophistication and affluence of our financial society, is increasing the proportion of the money that moves to or through the national money markets. This means that our financial institutions have to go to the national money market for a larger and larger share of their funds. That is all right. It is good. It is efficient and insures that the saver gets the best return on his savings. It does create an exposure to the confidence risk on the money that comes into our financial institutions. Whether it is banks or savings and loan associations, when money comes in from outside there is an element of confidence risk. That money brought in, acquired from outside, to finance community activities, does not have quite the same loyalty to the institution and to the community that money raised within the local area does. Therefore, it is a little more inclined when a rumor comes up to move someplace else in order to get about the same rate of return without the risk.

We have to have a banking system that can stand those kind of movements and one that is solid and sound enough so it does not foster that kind of rumor.

Mr. ST GERMAIN. Therefore, is it fair to assume, from your reply, that you would not favor a shift back to the asset management approach?

Mr. HOLLAND. I do not believe we can go back home again. I believe that this kind of evolution is a part of the increasing growth of our financial system. We cannot put it inside the bottle and go back a generation.

Mr. ST GERMAIN. I was reading a little bit of the history of the Fed and how it came into being. There was a chap named Nelson Aldridge from Rhode Island, who was credited with really having been the brain trust behind it all. Frankly, I went to high school in his mansion in Rhode Island, but it was no longer operated as a mansion. It was a very low-cost school. As a result thereof, I became very interested. As I recall, the real reason for the creation of the Fed back then was for agricultural areas, for a lot of small banks that did not have enough money at certain times of the year to provide credit to the community, to the farmers in the area, until such time that they were able to reap their harvests and bring the money in. So the Fed was created in order to take from capital surplus to capital short.

Their shortages were of short term duration. I guess the difference there is that there was a short term need, and once repaid, they did not have to rely or hope that that foreign money, so to speak, would remain in the community for any extended period of time.

Mr. HOLLAND. That is right. For the most part, they got that money on contract terms. They kept it, therefore, about as long as their farmers needed it. They borrowed on 30-, 60-, 90-, 180-day notes, from the correspondent banks, 90-day notes from the Federal Reserve. They had the money on contract for about as long as they needed it.

One of the attributes that developed in all of our financial institutions is that the money borrowed from the money market tends to have a shorter term maturity than the loans that the organizations put

the money into. A good banker or a good S. & L. man is always, to some extent, borrowing short and lending long. The art is not to do it too much, not to carry it to too great a degree. That is the balance we are trying to strike here, I think.

Mr. ST GERMAIN. Mr. Moorhead.

Mr. MOORHEAD. The chairman's comment about the farmers in history, pre-1913—most of our money crises came in the early fall, which was at the time that the farmers were in most areas, in trouble. It is an interesting historical point.

Thank you, Mr. Chairman.

Mr. ST GERMAIN. I have here a letter from the Department of Justice, originally received by the subcommittee, April 21, 1975, and I ask unanimous consent to place this in the record, as it is the result of the colloquy we had earlier.

[The material referred to follows:]

DEPARTMENT OF JUSTICE,
Washington, D.C., April 21, 1975.

Hon. WRIGHT PATMAN
Chairman, Subcommittee of Domestic Monetary Policy, Committee on Banking, Currency, and Housing, Washington, D.C.

DEAR MR. CHAIRMAN: This is in response to your letter of February 25, 1975, concerning the Federal Reserve Board's recently proposed amendments to the Bank Holding Company Act which would provide special expedited procedures for the acquisition of banks in emergency or "probable failure" situations. These amendments would also provide for the possible acquisition of a seriously troubled bank by a bank holding company whose principal banking operations are located in another state in certain situations where the public interest would be served by such an acquisition. You inquire as to whether the Justice Department was informed and consulted by the Federal Reserve Board and further request our thoughts and recommendations on the legislation in terms of antitrust policy and enforcement.

In response to your first question, I am aware of no consultation between the Board and the Department of Justice on these proposed amendments before they were submitted to Congress. Of course, we have long been aware of the lack of emergency procedures in the Bank Holding Company Act, and of its absolute restrictions on multi-state bank holding company operations.

We have been carefully studying this proposal with particular attention to antitrust policy and enforcement; however, the Office of Management and Budget has advised us that the Administration has yet to reach a firm conclusion as to what its position on the proposal will be.

We have advised the Office of Management and Budget of your interest in this proposal, and in the views of the Department, and have requested expeditious consideration of this matter. Please be assured that we will provide a full response to your inquiry as soon as possible.

Sincerely,

THOMAS E. KAUPER,
Assistant Attorney General,
Antitrust Division.

Mr. ST GERMAIN [quoting from preceding letter]:

In response to your first question, I am aware of no consultation between the Board and the Department of Justice on the proposed amendments before they were submitted to Congress. Of course, we have long been aware of the lack of emergency procedures in the Bank Holding Company Act, and of its absolute restrictions on multistate bank holding company operations. We have been carefully studying this proposal with particular attention to antitrust policy and enforcement; however, the Office of Management and Budget has advised me that as of yet, the administration has yet to reach a firm conclusion as to what its position will be. We have advised OMB of your interest, and the views of the Department, and have requested expeditious consideration of this matter.

Has OMB commented yet?

Mr. HOLLAND. No. They have not had any administration decision on it.

Mr. ST GERMAIN. Would you forward them to us? Maybe you will get them sooner than we will. We do not seem to be doing too well.

Mr. HOLLAND. We are this peculiar thing that is called the independent Federal Reserve System.

Mr. ST GERMAIN. I know about that.

Mr. HOLLAND. That means, Mr. Chairman, OMB does not send the responses to us. They collect them for themselves to get an administration position on a bill. They will tell us, in general, what those views are. They would not ordinarily supply us with those letters. That is a part of the distinction we maintain.

We have talked over this legislation with the other banking agencies and the Treasury. I feel confident in saying to you that you will see that they have a favorable attitude toward these bills.

Mr. ST GERMAIN. Mr. Wylie?

Mr. WYLIE. Thank you. Mr. Chairman. On page 17 in your statement, you say, similarly that the protracted hearing requirements of the case recommended disapprovals by the supervisory authority are ill-suited to a failing bank or bank holding company situation. You have discussed this, as I understand it, with Mr. St Germain. Would you remove the hearing requirement altogether? Or would you have the proceedings held—I do not know the word, secret?

Mr. HOLLAND. We would remove the whole thing.

Mr. WYLIE. You would remove the whole hearing procedure altogether.

Mr. HOLLAND. If I may say so, the pattern we are following here is the pattern the Congress itself wrote into the Bank Merger Act in 1966, when we established a procedure for bank mergers with the same 30-day delays and notices for hearings in case of adverse recommendations. The Congress provided for all that with respect to bank mergers. However, they said in these emergency and failing bank cases, all of these requirements can be waived. The approving authority can act forthwith in the interest of keeping the bank going. We are just taking that same approach and bringing the same provisions over into the Bank Holding Company Act, so that a bank holding company could play the same kind of role in a rescue operation that a bank could in a merger.

If we increase the number of opportunities for organizations to come in and bid to save a bank, we think we get more competition and a better banking system.

Mr. WYLIE. What you would have is an informal exchange of information.

Mr. HOLLAND. What happens in the case of bank mergers is that, whichever agency has the authority to approve the merger is in touch with the agency that is overseeing the bank in trouble. How do you feel about this? What is your view? We are talking on the telephone, because time is of the essence. If it is really a big organization, we will call somebody in Justice and say, this bank is coming apart; we are facing this kind of problem. Most of this is done orally, because we are trying to save hours when one of these situations starts to unravel.

Those bases are touched so that the action, when it is finally taken has, invariably in my memory, always been acceptable to all parties.

Mr. WYLIE. If it was acceptable to all parties, probably within a few minutes after the situation was known and discussion was held, and so forth, and under the Bank Holding Company Act, you had to wait 30 days?

Mr. HOLLAND. That is right.

Mr. WYLIE. And no witnesses show up for the hearing?

Mr. HOLLAND. You have to worry about that, too. Hearings could produce some of the kind of scare talk that could increase the chance that there would be a run on the little bank you were trying to save, before you could consummate the holding company acquisition.

Mr. WYLIE. That makes sense to me.

On page 22, you mention financial interest abroad. It says the only smaller bank strong enough to undertake such a venture may be those affiliated with powerful commercial or financial interests domiciled either in this country or abroad. What is the current law with respect to foreign interest takeover of an American bank?

Mr. HOLLAND. If you are referring to foreign individuals owning a controlling interest in an American bank, there is no prohibition. By law, they cannot, however, be on the board of directors of a national bank.

Mr. WYLIE. I am really trying to find out what you mean because in the sentence before that it says, "in most of our States, the number of locally owned banks, big and strong enough to absorb a large problem bank are very few." Then you say, "the only small bank strong enough to undertake such a venture may be those affiliated with powerful commercial or financial interests domiciled either in this country or abroad."

Mr. HOLLAND. I was trying, in a generalized kind of way, to describe the kind of organization that European-American Bank represented. European-American was a $2 billion bank, which would ordinarily not be big enough to handle a bank as big as or sick as Franklin was. But behind European-American were these very, very strong bank owners abroad so they were able to handle this kind of acquisition.

Mr. WYLIE. Should that be changed, or would you leave the law the way it is?

Mr. HOLLAND. I would not favor changing that part of the law. I would favor loosening up the law to let our big, out-of-State holding companies bid.

Mr. WYLIE. I see.

Mr. HOLLAND. I do not believe we are at the stage yet where it would be wise to try to outlaw foreign ownership of U.S. banks. I think we have more to lose than to gain by that.

Mr. WYLIE. On page 31, you say, "I described the general scope of our efforts and the problem areas on which we were focusing our attention, the attention of bank capital produced by the rapid expansion of bank assets, bank liquidity problems, particularly heavy reliance on liability management." Referring to "increased foreign exchange risks." To what extent was this type of risk responsible for?

Mr. HOLLAND. What caused public attention was the announcement in May, of the multimillion-dollar loss on foreign exchange contracts

which the Franklin auditors had turned up. Before that, there was a trickle of bad news about Franklin, including a report of very poor first quarter earnings. Then on that weekend in May, they had to announce that they had suffered these foreign exchange losses because of what looked like poor controls and fraud. That galvanized concern with Franklin and accelerated the rate of outflow of funds. It was very clearly an important contributing factor to Franklin's failure. Not that the loss was so huge, although it was big enough. It got to be over $40 million in the end. That was large, compared to Franklin's capital, and it had a shock effect that began to really breakdown confidence, in Franklin as an ongoing institution.

Mr. WYLIE. Even in view of that, you do not feel that we should make any changes in the laws, as far as the possibility of foreign interest takeover, in this concern?

Mr. HOLLAND. No, I do not. This was not a part of the foreign interest, as we saw it. These foreign exchange commitments are a part of the business of financing international trade, where our banks are making agreements to pay debts or transfer payments in foreign currencies to foreign banks every day in large amounts of money. That kind of business needs to go on in order to finance foreign trade.

What did seem bad to us in the Franklin case was that there were not the kind of controls, limits on how far they could go in speculating in foreign exchange, to keep it within the bounds that the bank could afford. It was like a gambler who was wagering more than he could afford to lose. That is a very bad way to do business.

When we started to investigate this area, we were not at all sure that we would not be here with requests for legislation. We found that circumstances were changing rapidly. Primarily, because bank managements all around the country had been alerted by these events to the kind of risk there could be in their foreign exchange departments. And we found sharply tightened controls or sharply reduced limits everywhere.

We looked at those actions and said, we will accept that kind of safeguard. We will also do stronger examinations of foreign operations. We will develop audit manuals on the kind of controls that should be used in supervising and controlling foreign exchange operations.

Mr. ST GERMAIN. The subcommittee will be in recess for a vote. We will be back presently.

[After recess.]

Mr. ST GERMAIN. The subcommittee will come to order.

Mr. Wylie.

Mr. WYLIE. If I can reconstruct, on page 34, Governor, you say amendments would be made to section 8 of the Financial Institutions Supervisory Act to eliminate the current requirement that acts of personal dishonesty be involved before officers or directors of a banking institution can be removed by a bank regulatory authority. Then you suggest that maybe the change will permit removal for gross mismanagement.

I am not real sure what you mean by gross mismanagement. Would that involve the personal incompetence of the individual involved, or would that be a matter of judgment on a bank examiner's part?

Mr. HOLLAND. It would be a matter of judgment in the end. A bank examiner could not trigger this. It would have to be decided by the agency. The law as it presently reads provides this power to remove an officer or director when both of two conditions exist: When he or she is doing something that is personally dishonest, personally proven dishonest, and is doing substantial financial harm to the bank.

Mr. WYLIE. That is included in the present statute?

Mr. HOLLAND. That is in the present statute.

What we are suggesting is to drop the first of those two tests, to drop the test of personal dishonesty leaving only the test of substantial financial harm.

Mr. WYLIE. I see.

Mr. HOLLAND. So we only have one test instead of two. The reason we are suggesting it is we have found on several occasions since we have had this law to work with that there may be cases where it was very clear that decisions being made by an officer were hurting an institution very badly. Indeed, this might well be said of C. Arnholt Smith. But, you could not get enough evidence to prove they were personally dishonest. Therefore, you were not able to remove him, at least at that point in time.

It is this endeavor to be in a position to excise that bad managerial authority a little earlier that brings us with this proposed to the subcommittee. I worded these proposals in general language to try to communicate the essence of what we are after. I did not deliver the legislative language to you. We do have it worked out in draft legislative language. Indeed, it has already been approved by our board.

We are working with the other bank regulatory agencies. We thought if we could work out uniform agreement among the three of us, it would make your job simpler. We should be within just a few days of being able to obtain agreement.

Hopefully we will be able to give you proposed language. There may be a few changes we will need to make if the other agencies see things that should be fixed up. I think it is going very well. I think we will have something up to you in short order.

Mr. WYLIE. The words "substantial financial harm" are words of art in the law then.

Mr. HOLLAND. They are in the law now.

Mr. WYLIE. They have been defined by court cases or regulations.

Mr. HOLLAND. May I consult my lawyer on that?

We have not had a case yet that was carried through to the point where a court defined that term. We have brought a case or two. The most recent time we brought one, the fellow got out of the bank before we could carry it through to a conclusion.

Mr. WYLIE. The cases that you have brought, then, have involved cases involving personal dishonesty?

Mr. HOLLAND. That is right.

Mr. WYLIE. How about putting in there, instead of removing "personal dishonesty," "personal dishonesty or financial harm."

Mr. HOLLAND. That would be fine.

Mr. WYLIE. Since we already have had cases.

Mr. HOLLAND. The one thing we want to be careful of is not to have someone subject to removal because of a parking ticket. There

should be some magnitude of personal dishonesty. We could take that under advisement and see if there is a way that could be phrased.

Mr. WYLIE. The point I was attempting to make there, there are areas of judgment that we do not want to get involved in or we do not want some bank examiner to trigger this procedure through his suggestion that the person was not using reasonable judgment in the operation of the financial institution.

Is that not a fair statement?

Mr. HOLLAND. That is very true. We do not want to get in that business either. That is why I used the language "gross mismanagement."

Mr. WYLIE. Rather than "due diligence." That amounts, I suppose, to gross negligence. The word "gross," again, is a word of art in the law which we all know.

Mr. HOLLAND. We will see if we cannot sharpen that up when we present this to you.

Mr. WYLIE. Thank you. I believe that is all the questions I have right now.

Mr. ST GERMAIN. Governor Holland, once again, we will consider the balance of your testimony as having been read and a part of the record. We have already been into some portions of it. There is quite a bit I want to go into personally. If you have any highlights, I am sure that my questioning will allow you to highlight a great deal. If there is anything you want to highlight, you may.

Mr. HOLLAND. Just a few words off the cuff. I am glad to have been able to point out where we stand on these legislative proposals. I am aware of the fact that the last time I saw you, sir, I talked about getting these proposals to you in the first quarter of 1975, and we slipped 4 months. I think that is a product of finding it tougher to crack some of these nuts than anticipated and also harder to find the time to get at them in the face of other problems.

We are, we believe, very close to laying these proposals before you. I think they will merit your attention.

Beyond those legislative proposals, we have found as we went through this broad review—and we are still in it, we have not finished it—that there were not many other areas where we thought we had to have legislative changes in order to produce improvements in the situation. That is the philosophy behind the next 10 pages of my statement.

We realize that if we changed our administrative practices, if our sister agencies did also, if we put out some new regulations, if we broke some new ground in terms of supervisory attitudes on things like capital and liquidity, we could produce an appropriate improvement, an appropriate remedy to some of the things that we now look back on and say we wish had not happened. Since it seems to us that that is the way an agency like ours ought to proceed, we ought to use the authorities we now have as far and as well as we know how to use them. That is what we have been trying to do.

A number of the changes we propose will involve changes for banks, but the last issue we raise is change in the bank regulators. After looking at all of the problems that we have thus far been able to perceive in the banking system, we looked at how well we thought the

regulators had done, how well we thought the regulatory structure had sufficed in helping us to deal with those problems, and came to the conclusion that a change was desirable. But it was not essential.

That is, we think that we have done—bank regulation and supervision have done a number of things right. There are some things that could have been done better. We would like to see some changes that would help it be done better.

We concluded—and this does not take legislation—that we in the Federal Reserve System not only wanted to play a part in making it better, but indeed, as we consider monetary policy these days, we need to be sufficiently involved in bank examination and supervision to understand banks and banking. We need that involvement and understanding to better perform our monetary policy functions, not to be just ivory tower theorists. We need it because in this kind of world of more money flowing through the money market, more international flows as well as domestic flows, some of these regulatory standards are part of what makes monetary restraint and monetary ease work.

Therefore they need to be better integrated. There needs to be a more careful consideration of the effect of each on the other if we are going to have as good as possible policy in each of those fields.

That brings us to the second conclusion stated here; that we wanted to stay in the regulatory and examination business. We think it makes our monetary policy better, and we believe our perception of monetary policy makes bank regulation and supervision better both as we administer it, and as we report on those relationships to our sister supervisory and regulatory agencies.

When it comes to the structure itself, there have been a lot of suggestions made over the years. My organization or members of my organization have made some of those suggestions, both modest and extreme. Many other people have made suggestions as well. As we have thought about them, we have come to the conclusion that there are disadvantages as well as advantages to a number of these radical changes, and frankly, that the problems, serious though some of them are, are not of a kind that require changes in the regulatory system in order to be able to do anything about them.

The more we thought about it, the more we believed that there was a step that we could take that would begin to produce more coordinated, unified Federal decisionmaking at the bank examination level, that we could do soon, that we could do effectively, that we could do flexibly. That is to set up a Bank Examination Council as outlined in the last part of the statement. We believe this council can give us experience and insight as to how well the agencies can work together and how far it is worthwhile to go in trying to consolidate the Federal bank regulatory and supervisory agencies.

We can see this group dealing with some of the detailed problems with a strict sense of accountability and more responsibility for initiative than you can have when there are three separate groups with divided responsibility.

And we think that it may give us a worthwhile insight into what that additional degree of unification, working closely together, can accomplish. We believe that it is worth a try. We think it would be helpful, that it would make a measurable difference.

Now, with that, I have given you the essence of where we stand. We expect our study to keep going for a number of months. There are still many other areas that will take a long time to carry through to completion.

I think I have said enough about the statement to give you a flavor of the direction it is taking, and I believe that we have now given you a sense of most of the legislative proposals that we will be making; they are all mentioned in the statement.

Mr. ST GERMAIN. As you yourself stated, I think it was in December, you told us that you would have some recommendations in the first quarter; Frank Wille of FDIC gave me to understand by May 15, May 30, when he and I had a very delightful conversation, that the FDIC would have its recommendations.

Of course, you did not use outside consultants, nor did the FDIC.

Mr. HOLLAND. We used one.

Mr. ST GERMAIN. You did? Whom did you use?

Mr. HOLLAND. Prof. Roy Schotland.

Mr. ST GERMAIN. Did he have a very large contract?

Mr. HOLLAND. No. It was on a per diem basis, I believe.

Mr. ST GERMAIN. You did not hold over the whole task?

Mr. HOLLAND. He did one small part of it.

Mr. ST GERMAIN. An accounting firm, such as the Comptroller retained for $1 million. It appears to me that the holdup here seems to be since you were ready back then, as was the FDIC, that the holdup is coming from the consultants that were retained to do the whole job for the Comptroller's office.

Is that not the case?

Mr. HOLLAND. You tempt me.

Mr. ST GERMAIN. In a few minutes I will give you a darned good reason to yield to temptation.

Mr. HOLLAND. I have to admit that we were not agreed within the Board either. We had some more studies we had to do for some weeks after the end of April. April and May we have been hard at it, trying one idea and another, seeing what is workable and so on.

Mr. ST GERMAIN. Has the Comptroller received the consultants' reports yet?

Mr. HOLLAND. I do not know the answer to that for a fact. I took it from newspaper reports that the answer was yes. I do not know that.

Mr. ST GERMAIN. In your deliberations with the Comptroller and with the FDIC, has the Comptroller had available the consultants' reports and the findings?

Mr. HOLLAND. He made some references to me about it.

Mr. ST GERMAIN. The Subcommittee on Financial Institutions has not been able to receive a copy of the report yet.

Mr. HOLLAND. I do not have a copy of the report.

Mr. ST GERMAIN. Frankly, Governor Holland, I might state in this last part of your presentation I am rather disappointed. I had hoped for a little more.

Now I quote from a speech that was given in October 1974 in Hawaii:

> Those of you who have been intimately concerned with regulatory matters will realize that I have oversimplified, that, our system of paralleled and sometimes overlapping regulatory powers is indeed a jurisdictional wrangle and boggles the mind. There is, however, still more serious problems. The present regulatory sys-

tem fosters what has sometimes been called competition in laxity. Even given the most favorable light, the present system is conducive to subtle competition among regulatory authorities, sometimes to relax constraints, sometimes to delay corrective measures.

I need not explain to bankers the well understood fact that regulatory agencies are sometimes off against one another. Practically speaking, this sort of competition may serve a useful purpose at a time of easing overly cautious banking procedures after the wake of the Great Depression, but the danger of continuing as we have in the past should be apparent to all objective observers.

The range of possible solutions is broad. Some will doubtless conclude that it would lie in improved coordination among the multiple bank regulatory agencies together. My own present thinking, however, is that building upon existing machinery may not be sufficient, and a substantial reorganization will be required to overcome the problems inherent in the existing structural arrangement.

I might give you another quote. Last fall Chairman Burns gave this speech in Hawaii to the American Bankers Association. Subsequently at least three Governors of the Federal Reserve expressed themselves on the subject of bank regulation structural reform. Comptroller Smith defends the present structure that he terms a trichotomy. In his advance statement for tomorrow he states: "The now famous phrase of competition in laxity may be no more than a description of the healthy flexibility which presently exists."

You know, if you say to us that all that is necessary is maybe a few legislative proposals that were being brought forth, to wit: With respect to members of the board of directors and the offices, better powers for removal, and that is what you have described in your statement, I think that sort of confirms what Chairman Burns said. You know, I read an advance from a team that did the study for the Comptroller. When I read this—I think it was back in February—I was a little bothered by it.

It says it appears, I am not quoting verbatim, I do not have it before me—it stated that essentially the present regulatory system was sound. It did not need any legislative changes. They just had to do a better job with what they had.

Now, I am bothered because on the one hand we hear you do not need any changes. Frankly, the statement does not really call for any drastic changes. On the hand, we are told it is evident that the agencies have not been coordinating. There has been a competition in laxity, a reaction to the overt regulation right after the Great Depression, and I am bothered.

Does this indicate that the regulatory agencies over a long period of time have just been plain sloppy, that they have had the tools and have not used them?

Mr. HOLLAND. I think that it is something that needs to be thought of not as sloppiness so much as learning experiences. All of us have learned things from these last couple of years that we did not know before. I think we are running tighter ships as a result. That is the single most important thing that has happened. Both bankers and bank regulators have learned something in these last few years.

I still believe, as does the majority of the Board, as you can see on page 57, that the present diffusion of authority and responsibility among three Federal agencies is conducive to some confusion, uncoordinated initiatives, occasional delays and misunderstandings, sometimes to a subtle competition to relax or forego appropriate constraints on banking institutions.

We still believe that that takes place.

Mr. ST GERMAIN. Is there, perhaps, a problem that always occurs when there is an attempt at reshaping? In other words, the Fed, when it really sat down and discussed this, decided, that, we are giving up some of our authority, the other agencies likewise. Nobody likes to lose authority and personnel.

In your statement you mentioned the fact that very good technical personnel might be lost, and so forth.

Does that enter into it?

Mr. HOLLAND. I hope not.

Mr. ST GERMAIN. It is a human element?

Mr. HOLLAND. It is human. I do not claim to be inhuman. I think what is involved here is that it is easier to perceive the disadvantages and the weaknesses of the system than it is to perceive its strengths.

Mr. ST GERMAIN. The present system?

Mr. HOLLAND. The present system of Federal bank regulation. I was doing as much complaining in Board discussions as anybody about some of the shortfalls and misses in the past few years of the kind that this sentence refers to. There are shortfalls. We need to eliminate them. There are also some strengths that come out of the present system. There is the risk of the grass appearing to be greener on the other side of the fence.

We came to the conclusion first, that it does not take a monolithic bank supervisory and regulatory agency to accomplish the most important things that need to be accomplished. Second, that it is not so easy to figure out how to preserve some of the vitality, the opportunity for flexibility and initiative which the present system has, when you move, when you try to conceptualize a single Federal bank regulatory agency. As we thought about this problem we developed the idea of a unified group, not at the top but at the level that is setting the standards for how banks are treated by their examiners.

We believe it is the examination area that most needs scrutiny and work on, in the light of what happened in the last couple years. That is what this Federal Bank Examination Council would do. Each of the three agencies would delegate to a representative on the Council the authority to make decisions, as a Council, in specified areas of Federal bank examination standards and procedures.

We believe that this would be a very useful way to experiment with an endeavor to get the force and the accountability of a more unified attack on examination problems, and not at the same time risk losing the vitality and the flexibility that comes from having more than one supervisory organization.

Moreover, we were conscious of the fact that we ought to be talking about something that is doable, not something that is pie in the sky. We regard this as a doable program, the results of which will educate us and should be helpful to the Congress as you see how this program develops. It also would be meaningful to the banks that are subject to this examination.

That is the kind of experience we are looking for, as the next step in Federal bank regulatory restructuring.

Mr. ST GERMAIN. You really do not need statutory authority to establish this Federal Bank Examination Council.

Mr. HOLLAND. No. I think that is one of the virtues; we can just do it.

Mr. ST GERMAIN. Do you intend to proceed to establish it?

Mr. HOLLAND. We have already started talking to the Comptroller and the FDIC about setting this up. When they are here before you you can obtain their view about it.

Mr. ST GERMAIN. Could you tell me now what their reaction is?

Mr. HOLLAND. I am not sure. They see some strengths and weaknesses. They are probably working on those ideas right now, getting ready to tell you.

Mr. ST GERMAIN. Could it be with the absence of legislation you might not get cooperation?

Mr. HOLLAND. It is conceivable. I would like to think that would not be the case. I think we need to take this step.

Mr. ST GERMAIN. The coordinating committee, is that legislative or is that procedural?

Mr. HOLLAND. I think a fair statement is that it is procedural, but it is recognized by legislation.

Mr. ST GERMAIN. I recall one of the comptrollers boycotting the coordinating committee, a fellow by the name of Jim Saxon.

Mr. HOLLAND. He boycotted the Federal Deposit Insurance Corporation Board on which he served as a member by statute. He would not go to their meetings.

Mr. ST GERMAIN. I would like to ask you about that coordinating committee. It is composed——

Mr. HOLLAND. One member each from the Fed, FDIC.

Mr. ST GERMAIN. Let us go slowly. The Federal Reserve Board, the FDIC, the Home Loan Bank Board, and the Comptroller represents the Treasury?

Mr. HOLLAND. He represents himself.

Mr. ST GERMAIN. Is he thought of as representing Treasury?

Mr. HOLLAND. He is thought of as representing the Administrator of National Banks.

Mr. ST GERMAIN. Does the Treasury have any input into the coordinating committee?

Mr. HOLLAND. They will suggest agenda items. They may suggest a meeting be called. Sometimes they will attend the meeting. They are not a member but they are an interested observer and kibitzer.

Mr. ST GERMAIN. When Treasury kibitzes, they are a pretty powerful kibitzer, are they not?

Mr. HOLLAND. They do not come in saying I think you fellows ought to decide this. It is not that kind of kibitzing. They have many financial responsibilities. When they say something is a problem, we all think about that problem.

Mr. ST GERMAIN. Are you giving consideration to inviting the Administrator of the NCUA to join the coordinating committee?

Mr. HOLLAND. I had not. I think for some purposes that that would fit the purposes of the coordinating committee.

Mr. ST GERMAIN. Yesterday we were able to discuss that task force, you know, that HUD, the Home Loan Bank Board has. Now they are inviting the FDIC and Comptroller to come on board.

Do you now know? Grady Perry asked General Nickerson to join yesterday? Credit unions are becoming a very strong factor.

The other thing that bothers me when I look at the composition in the letters we are getting now, specifically the letter I got back from Chairman Burns with respect to IRA accounts and the differential there, I get the impression that there is a little stacking in the coordinating committee.

Who do you have representing the thrift institutions? You have the Home Loan Bank Board. The FDIC represents both commercials and the mutuals that exist in 19 States, right?

Mr. HOLLAND. That is right.

Mr. ST GERMAIN. Then you have the Comptroller and the Fed.

Mr. HOLLAND. We like to think the savings deposits in commercial banks are an important part of the Nation's thrift system, too. The coordinating committee does not decide anything by a majority vote. It has no decisionmaking power. All we do is consult together. By law, once we have talked together we can each go back and vote our respective convictions in the light of that consultation. We do try as men of goodwill to see if we cannot come to an agreement as to what would be desirable action. There are times when we are not able to do that, and we have to simply consult and go back and do the best we can.

Mr. ST GERMAIN. Going back to what you said a little earlier, you stated there was difficulty in formulating proposals because you had been quite busy. If you did not have this problem of supervision in regulation, would that not give you more time to do other things?

Mr. HOLLAND. The reasons for most of the delay that kept us from getting at it were problems in the areas of supervision and regulation.

Mr. ST GERMAIN. I got the impression. I will check the transcript later.

Mr. HOLLAND. Did I say monetary policy?

Mr. ST GERMAIN. You said you were busy with other things. My impression was that other things intervened. You were very busy.

Mr. HOLLAND. We were spending some time on monetary policy.

Mr. ST GERMAIN. Credit allocation, GAO audits of the Fed?

Mr. HOLLAND. We spent a little time on that, too.

Mr. ST GERMAIN. That would give you more time to spend on those items, although you have been pretty successful to date on those.

Mr. HOLLAND. We are not the last in the pack in terms of regulatory reform.

Mr. ST GERMAIN. Mr. Moorhead.

Mr. MOORHEAD. Thank you, Mr. Chairman.

Governor, was one of the alternatives that the Fed considered, that the Fed should take over the examination of national banks, the transfer from the Comptroller to the Federal Reserve?

Mr. HOLLAND. Yes; we thought about it. That is our study group that was to consider alternatives reflected on it. That is one of the alternatives. It was one way of accomplishing one of the objectives we thought about of making sure that monetary policy and supervisory policy learned from each other.

We were dissuaded from this alternative for two reasons. Some of us were more persuaded by one of the reasons, some by another. Both

Mr. St Germain. That is usually pretty expensive money, is it not?

reasons were enough to persuade a majority of the Board that this was not the right way to go. One was the problem the chairman just alluded to. If we had all of the supervisory and regulatory powers, plus all the monetary policy responsibility, we might find we had—I will not say more than we can handle—but we might find we had enough that we would begin to spend not as much time as we would like on monetary policy problems. We feel that we cannot afford to shirk monetary policy, we would not be fulfilling our responsibilities if we shirked that.

Second, we were aware and we recognized that there was some validity to the concern about getting too much decisionmaking power in one monolithic institution, and putting it all in one bank supervisory agency would reduce the checks and balances that we now have in our system. Those checks and balances create inefficiency. Sometimes they create uncoordinated activities and sometimes cause problems, but they are a check and balance on individual judgment and arbitrary and authoritarian attitudes. I would like to think we do not take such attitudes, but we recognize the danger as an argument that deserves some attention, and that it might happen.

Mr. St Germain. Talking about concentration of power in a monolithic agency, should the Fed really make a statement like that? Who has the power over the monetary policy in the country?

Mr. Holland. We have it, as your creature.

Mr. St Germain. Are you not a monolithic, independent agency?

Mr. Holland. In the field of monetary policy?

Mr. St Germain. Yes.

Mr. Holland. We feel we have a lot of hangers-on and others interested. It is true we have strong power in that area.

Mr. St Germain. Is that bad?

Mr. Holland. We think it is good.

Mr. St Germain. That being the case, would it be bad to have a monolithic agency in the area of supervision and regulation, if we had a member of the Fed as a part of this group?

Mr. Holland. I see that as a possible alternative.

Mr. St Germain. The fact that it is monolithic and has a great deal of power does not mean it is bad, does it?

Mr. Holland. It means that you have reduced the number of checks and balances in the system. That we do recognize. I meant to be responding to what I thought was Congressman Moorhead's question about putting it all together, all supervisory regulatory policy and monetary policy in one organization.

Mr. Moorhead. To continue FDIC but reduce from three to two the Federal agencies involved in bank examination.

Mr. Holland. We have talked some about that, too. To a lesser degree than if you folded all three organizations into the same entity, the same arguments apply to this proposal. Virtually, any bank of any size in the country feels that it has to be insured. If it has to come to one Federal agency for insurance, and that same Federal agency also regulates, and runs monetary policy, and issues charters, that is, I think, very close to one-stop bank regulation. It has some of the risk of arbitrariness and lack of checks and balances that I talked about.

I am not maintaining that this would happen. I am talking as a political scientist not as a banker or economist. I do think there is rea-

son for some concern. If we were creating a new system, I do not believe I would advocate having a Comptroller as the chartering office, and having a Federal Reserve membership relationship also. I do not believe that I would say we should start out with two separate functions. But we have the two. They are both performing their functions at the moment. We are getting along rather well together.

If I may say so, I think it is the better part of wisdom and the better part of discretion to take a less ambitious and less irreversible step than to try to put them together. Let us start in the area of examination standards where we know we want to make a change. We want to try to update and improve the examination process. We want to do it on as uniform a basis as possible. Let us see how that goes. That makes more sense to us.

Mr. MOORHEAD. Considering this presentation to the subcommittee, did the Federal Reserve ever consider recommending legislation requiring all State-chartered banks to be members of the Federal Reserve System?

Mr. HOLLAND. Yes. We have sent up legislation to the Congress that requires all depository institutions to meet Federal Reserve requirements, which we think is the key to the monetary side of our regulatory structure. If that were in place, we think that would take care of the most important part of our concern. In that limited sense, we have proposed it.

Mr. MOORHEAD. They do not want to automatically be members because they would have all the disadvantages and none of the advantages?

Mr. HOLLAND. I think that is right, Congressman Moorhead. Perhaps that is a little extreme. Maybe we would make decisions of a regulatory nature that they do not think their State bank supervisor would make, even if they had to meet our reserve requirements.

I hope Board members will always be intelligent enough to make supervisory decisions at least as good as the States. I hope that we would not drive them out of the System that way.

Mr. MOORHEAD. Mr. Chairman, was the Fed asked to comment on these bank privacy bills?

Mr. ST GERMAIN. Yes. We questioned the Fed on that earlier. If you would like to, I am sure Governor Holland would be happy to respond.

Mr. MOORHEAD. I would like to go out of order, and go back to title III of H.R. 8024, where you suggested the possibility of a pilot study. I wonder if you considered whether the privacy bills before the subcommittee might affect the desire, design, and feasibility of such a study, and has the Board considered how these bills might affect economic and socioeconomic research in general?

Mr. HOLLAND. We did not directly consider how the bank privacy bills, if they became law, would affect our proposals for a pilot study. We did not get those two issues on the table at the same time and reconcile them. I can see if the privacy legislation bills became law before the pilot study was done, that we would then have to be very careful that the privacy legislation provides for exemptions for supervisory purposes, and that the pilot studies be done for supervisory purposes, and that none of the individual loan information be revealed. At least that would be my thinking of the relationship between those

two proposals, and that is the only way I could see at the moment to reconcile it.

I would be glad to go back and reflect upon that some more and give you something for the record. You frankly asked a question we did not consciously face.

Mr. MOORHEAD. If that is all right, Mr. Chairman, I would like to have the Governor reflect and submit anything more.

Mr. ST GERMAIN. I think the Governor should check the testimony yesterday by the Bureau of the Census. The technique that is contemplated in title III is the same used by Census. Of course, there is a protection against release of any information that would tie it to any individuals. They use census tracts with approximately 4,000 people. The whole thing would be developed in such a manner so that it would relate to aggregate figures and not to data on individuals.

The privacy bills have to do with privacy of the individual. There really is not any conflict.

Mr. MOORHEAD. The difference is in the proposal that the Governor made about a pilot study, which would actually go out and ask individuals whether they asked for loans and were turned down to find out, I think you called it, the quantity and quality of the demand for loans. There might be a little bit of difference in the pilot study than there is in the broad-based title III study.

Mr. HOLLAND. I think that is right, Congressman.

Mr. MOORHEAD. Thank you, Mr. Chairman.

[Governor Holland subsequently submitted the following information for the record:]

As we have indicated, our proposal calls for a pilot study of credit flows in relation to community needs based on a sampling of financial institutions within several standard metropolitan statistical areas, and oriented to general objectives prescribed by Congress, with provisions for carrying out the study adopted by each agency for the institutions supervised by the agency. In this regard, we have also proposed that broad discretion be given to the agencies in determining the specific information to be obtained and the survey methods and procedures to be utilized.

As elaborated below, this type of study would probably not be possible under the financial privacy bills in their present form except on a basis too limited to meet the requirements which we would all expect such a study to serve.

On Congressman Moorhead's question concerning the implications of the proposed privacy legislation for economic and socio-economic research in general, it may be said, first, that the bills would seem to affect most directly the law enforcement activities of the Departments of Justice and Treasury. They do not appear intended to limit the Federal or State or other regulatory agencies in carrying out their responsibilities, although we believe that this issue should be clarified more precisely as noted in the Board's letter of July 15, 1975, to Chairman Reuss. If, as the Board also suggested in that letter, the legislation incorporates a statement to the effect that nothing in the Act shall be construed to prevent collection of statistical data under procedures that insure protection of the confidentiality of individual reports, one aspect of the problem so far as the body of our economic and socio-economic series is concerned would be minimized to a considerable extent. Such a classification would have a similar effect on our pilot study proposal if the latter were adopted by the Congress.

If such a change were not made, however, and if the legislation were interpreted to permit collection and dissemination of information on individual items only for supervisory purposes, the implications for our statistical data base and the research that depends on it (including our proposed pilot study, if adopted) would be quite serious on a number of grounds. Many of our present series, as you know, are derived from samples of institutional respondents cooperating on a voluntary basis. Our experience generally has been that such respondents tend to have a

greater-than-usual concern for the quality of the results and the analytical purposes being served. Even if the term "supervisory" were defined less strictly, we and others concerned with economic analysis of financial markets could lose a great deal in terms of our flexibility with respect to sample design, speed in securing informational results and, I suspect, the quality of reporting.

In view of the ambiguities raised by certain language in the bills as presently written, we might possibly lose even more if we or any other statistical collection agency operating outside the supervisory area were required to obtain individual customer authorization as a condition for securing the cooperation of a reporting institution even when the information actually to be reported were to be presented to the collecting agency only in aggregate terms. This type of condition would not only greatly inhibit the willingness of some financial institutions to participate in a particular sample, but would also make it difficult, if not impossible, for us to interpret the results. Moreover, even if the difficulty imposed by such reports could somehow be met, this condition would add additional cost to the expense of collecting them.

Mr. ST GERMAIN. Mr. Wylie.

Mr. WYLIE. Thank you, Mr. Chairman.

The Chairman, Mr. St Germain, referred to the Federal Reserve Board as a monolithic organization, and then you suggested that you would like to have nonmember banks come within the reserve requirements of the Federal Reserve System, which indicates it is not monolithic, to that extent, at least as far as monetary policy is concerned.

Mr. HOLLAND. I made a kind of loose and facetious reference to hangers-on. I was trying to allude to a number of things with that reference. One of the things I had in mind was that there are many banks that are not subject to our monetary control, and this is an inhibition on what we can do. Another comment I had in mind and did not make, but maybe I ought to—here is how the Congress in its wisdom when it designed the Federal Reserve System and gave it this sort of special independent niche, recognized that it was taking it out from some of the check and balance arrangements.

They created checks and balances within the Federal Reserve System. Take a look at the authority of any one member of the Board, the Chairman himself, the role that the Federal Reserve banks play vis-a-vis the Boards of Governors. And there are checks and balances built throughout our operations which guard against arbitrary acts.

Mr. ST GERMAIN. I will not ask the gentleman to yield, but I will get back to it.

Mr. WYLIE. Is there a difference between bringing the nonmember banks within the reserve requirement of the Federal Reserve and combining the functions of the Federal Reserve and the Federal Deposit Insurance Corporation and the Comptroller General, as far as examination and regulation is concerned?

Mr. HOLLAND. I think so. I see the former as a statutory action needed for purposes of monetary policy. I see the latter as a administratively permissible action now that could help to achieve more uniform ways of treating, more updated ways of treating banking and particularly misbehaving banks.

Mr. WYLIE. Probably I should have said, do you see any difference—I think there probably is—in bringing all of these agencies under the function of the Federal Reserve, as far as examination and regulation is concerned? And the thrust of my question is, having that authority and power would give you considerable clout over nonmember banks, would it not, which might have the same effect as bringing them under your supervisory control, as far as reserve requirements are concerned?

Mr. HOLLAND. It need not, but it might. I see what you are getting at, Congressman Wylie. There are two alternative avenues, here. To some extent, there is some overlap in what eventuates in the end. If all banks are required to meet reserve requirements, then it may be that a number of them would choose—as Congressman Moorhead suggested—many of them might choose to become members of the Federal Reserve. That is not what we are after with that suggestion. I can see that that may well happen, and if it does, then they are subject to our examination and supervision.

Mr. WYLIE. What percentage of banks, commercial banks, are members of the Federal Reserve now? I have heard this number before.

Mr. HOLLAND. At the end of 1974 there were 5,782 member of the Federal Reserve System. All the national banks are members of the Federal Reserve System. That is 4,710. Another 1,072 State-chartered banks are members of the Federal Reserve System.

Mr. ST GERMAIN. How about assetwise?

Mr. WYLIE. That was my next question. How about percentage of deposits?

Mr. HOLLAND. About three-quarters of the Nation's deposits, demand deposits, are held by members of the Federal Reserve System.

Mr. WYLIE. Seventy-five percent——

Mr. HOLLAND. We have suffered a little more erosion this year. It may be down to 72 percent, in that general range.

Mr. WYLIE. Do you think bringing nonmember banks under the Federal Reserve Board for purposes of reserve requirements might undermine the present dual banking system might or might not—I am not trying to put words in your mouth?

Mr. HOLLAND. No, I do not think so. That depends on what you mean by dual banking system. We have 50-State bank supervisory organizations, three Federal supervisory organizations. If by dual banking system one means a system of State chartering and an alternative Federal chartering, it seems to me that the option of choosing State or Federal chartering will continue to be open under our proposed system of reserve requirements on all depository institutions. I have heard comments that there would then be no reason why banks would not join the Federal Reserve. I would like to think that we treat them well enough that they would.

One of the things we propose in the bill is to give any nonmember bank access to the discount windows when he meets our reserve requirements. I would say he gets the most important advantage of membership right along with the painful part of membership, reserve requirements.

I could see why banks would not become members of the Federal Reserve. They may feel they have an advantageous State-chartering arrangement and that they should stay there.

Mr. WYLIE. You are suggesting that perhaps some sort of a tripartite commission and agency made up of a representative of the Fed and the Federal Deposit Insurance Corporation and the Comptroller General's office be the supervising agency over bank examinations, and that all bank examinations be channeled through that organization, or at least these three persons would have supervisory control over the bank examinations.

I wonder if that would resolve the problem—I am just searching here right now—because during the hearings last November and December, and here today, as a matter of fact, there was information that the U.S. Bank in San Diego was in considerable difficulty as far as bank examination were concerned, the information which was brought to the attention of the regulatory agency and was not acted upon. I guess what I am really saying is, finding by bank examination may not be enough. Maybe there ought to be one agency that would have the regulatory authority, or tripartite board like this which would have the regulatory authority.

Mr. HOLLAND. This proposal in my testimony is no revolutionary panacea that is going to solve all the problems. I would be the first to admit that. We do not even advocate that it cover all bank examinations and handle all bank examinations, only that it try to work out improved uniform bank examination standards in areas that are delegated to it by the three Federal agencies.

Then those standards would be taken out and applied by the Comptroller's examiners, by the Federal Reserve examiners, by the FDIC examiners. One of the areas in which they could be asked to develop better standards is a manual for the followup, in case an examiner produces a poor examination report, a sense of the order of enforcement proceedings. At what degree of examiner criticism should it be brought up to the regional area, and to the national level? We could develop a clear and more uniform understanding of what will be done in the way of followup in a typical case, once an examiner begins to turn up a problem situation.

I do not know for a fact but I expect the other two agencies have done the same thing we have, speeded up and stiffened up their followup procedures. We could learn from each other on this council as to what would be the most effective way to police those followup procedures. We could also exchange information on this council on how we followup, and where we are finding problems. And I think that would keep us a little less likely to let the last few years experience be repeated.

Mr. WYLIE. I just have one more question I want to followup on. Is it possible that there might be good and valid reasons why a member bank would want to drop its membership in the Federal Reserve?

Mr. HOLLAND. I am afraid the answer to that is yes.

Mr. WYLIE. Should we address ourselves to those questions before requiring nonmembers to join, who will be subject to Federal regulations or restrictions?

Mr. HOLLAND. I think that would be a wise thing for you to do. I would say I believe that there are about three reasons. The most important reason is that Federal Reserve requirements make them give up earnings on the reserves they maintain with us, where almost every other reserve requirement permits them to get some kind of earnings, direct or indirect, on those reserves. That is, in effect, a kind of tax or dues for being a member of the Federal Reserve System. It is a heavy tax in this day of fairly high interest rates. And therefore, many banks say membership is not worth it. It is too costly.

One of the things this subcommittee might do is think whether it wants to levy the heavy tax on nonmember institutions, banks and S. & L.'s. Our own feeling is that it is unfair to levy that high a tax

only on those who voluntarily agree to subject themselves to it. Either the tax ought to be mandatory for everybody, or perhaps the subcommittee ought to consider letting the Federal Reserve pay some kind of interest on those reserve balances. It is not a net tax to everybody. The burden of monetary policy decisions rests more heavily on part of the banking system.

Mr. WYLIE. I was just thinking, trying to think of an advantage that a member bank might have. One might be——

Mr. HOLLAND. We have a long list of advantages that we checkoff to persuade them to stay as members. You asked me the disadvantage.

Mr. WYLIE. You said there were three. You answered one.

Mr. HOLLAND. The first one is the cost of reserve requirements, unless the Congress will authorize us to pay interest on reserves. There have been academic suggestions for that, that I think are well placed.

A second reason for withdrawing from the Federal Reserve is that they are unhappy with the quality of our regulations or examinations. It could happen that we would be doing things wrong, and that they would want to get out from under our regulation. On some occasions that has been the reason an organization has left the Federal Reserve.

A third reason is they may find themselves getting services from correspondent banks of the kind that duplicate what they get from us, and they decide they do not need the kind of services that the Federal Reserve offers.

Mr. WYLIE. Are you gaining or losing members right now?

Mr. HOLLAND. We are losing in terms of percentage of the Nation's total deposits. The rate of loss has stepped up since interest rates have risen and, in effect, the earnings loss of their maintaining reserve balances with us have grown. It worries us.

Mr. WYLIE. Monolithicity is declining?

Mr. HOLLAND. We are being eroded relatively rapidly.

Mr. ST GERMAIN. By the same token, the legislation that came up last fall and again this year which would require membership indicates that you are hopeful of recapturing a little more.

Mr. HOLLAND. I recognize that this is a matter of definition.

Mr. ST GERMAIN. I think one of the reasons is because the examination procedures and the regulatory procedures vary from State to State and oftentimes they are a little easier on State supervision. As a result thereof, they change over there.

Mr. HOLLAND. Yes.

Mr. ST GERMAIN. I think we ought to talk about holding companies a little bit. We have not talked very much about them, have we? You stated, I think in one instance that we are trying to determine to what extent, if any, bank holding companies and their expansion into nonbanking areas, may have contributed to financial strength and financial difficulties. We expect this effort will shed some useful light on this subject that has at times stimulated sharp divergences of views.

Now that you have been attempting to look more broadly at the bank holding movement as it has unfolded from 1970 to 1975, have you yet reached any conclusions?

Mr. HOLLAND. Some, but we let that study come along with a lower priority on it than some of the others we have been talking about, the failing bank legislation and related subjects.

Mr. ST GERMAIN. Has not the holding company situation had an effect on the failing banks also?

Mr. HOLLAND. Oh, yes; I meant by this language to be referring to our analysis of the broad sweep of what has developed under the holding company legislation.

Mr. ST GERMAIN. Have you come up with one conclusion?

Mr. HOLLAND. Yes; I will express this as a personal conclusion, Mr. Chairman, because my committee has not yet voted on it, nor has the board as a whole.

While the studies are still incomplete, it is clear to me, that for one thing, holding company banks, holding company organizations, leverage more than do independent banks. There is a tendency to work their capital harder, to pile up more dollars of liability per dollar of equity capital in a holding company structure than either in the independent bank system of similar size or in nonbanking competitors that are in the same lines of business as the nonbanking affiliates and the bank holding company.

Mr. ST GERMAIN. Can you refer to any specifics?

Mr. HOLLAND. In terms of numbers?

Mr. ST GERMAIN. Types of activities.

Mr. HOLLAND. This evidence is clearest in the mortgage banking business, and in the consumer finance business.

Mr. ST GERMAIN. How about in the area of real estate investment trusts?

Mr. HOLLAND. There the only role bank holding companies get into is to have an affiliate which advises a real estate investment trust.

Mr. ST GERMAIN. Ordinarily when there is a holding company with an affiliate that does the advising, do we not find that the bank itself has taken a rather heavy position in the REIT that is being advised?

Mr. HOLLAND. In terms of lending the funds?

Mr. ST GERMAIN. Yes; is there not one called Chase Manhattan, and exactly what are they paying back in interest to the bank now?

Mr. HOLLAND. One after the other of the REIT's, whether bank advised or not, have renegotiated downward the interest rates on their loans from banks and other lenders, because of their own problem of lack of earnings.

Mr. ST GERMAIN. That was down to 2 percent, was it not?

Mr. HOLLAND. I would not be surprised. I do not know the precise rate on that loan. I would not be surprised if it were that low. It has been brought down on a number of loans, as a part of a workout procedure.

Mr. ST GERMAIN. That does have a bit of an effect on the bank that is a part of the holding company, does it not?

Mr. HOLLAND. Oh, yes; it means it has lost a piece of its earning flow.

Mr. ST GERMAIN. Tell me, what are the procedures used to evaluate improvement and update bank and bank holding company supervision at this point in time, other than that which you have described to us?

Mr. HOLLAND. I tried to put in the statement a very summary reference to them. We have launched a system of ad hoc reports that grew

out of conversations and personal contacts with the holding companies and their affiliates. We have launched a program of on-site inspection, sending our examiners right into bank holding companies, or their affiliates, where we sense trouble. We have established for the larger holding companies, a requirement that they report to us every quarter on their intercorporate transactions and on the structure of their assets and liabilities. We designed that as an experiment, and we are working to change it a little more in light of the first month's results, to focus on the problems, and, of course, we get an annual report from each one of these organizations.

In addition, we are aspiring to a partly computerized information system that gathers reports from these organizations and flags extraordinary deviations from ordinary routines and business, so that our examiners and investigators can check back.

Mr. ST GERMAIN. Do the examiners actually examine the affiliates, the activities of the affiliates, of the bank holding companies?

Mr. HOLLAND. They do, when we think we have a problem case.

Mr. ST GERMAIN. Are they competent? Are they trained? Do your examiners know anything about the customs brokerage business?

Mr. HOLLAND. We are trying to educate them in the various holding company lines of endeavor.

Mr. ST GERMAIN. Credit insurance and life insurance.

Mr. HOLLAND. Credit insurance?

Mr. ST GERMAIN. Not credit insurance; life insurance.

Mr. HOLLAND. Credit life insurance is the only kind of insurance. Credit related insurance is the only kind of insurance we will let holding company affiliates write.

Mr. ST GERMAIN. How about travel agencies?

Mr. HOLLAND. We have not acted on that one yet.

Mr. ST GERMAIN. You do not have any examiners that know much about travel agencies, do you?

Mr. HOLLAND. No. The place where we have sent our examiners thus far have been into those kinds of affiliates that have enough assets and liabilities in transactions, to represent a significant financial risk. Travel agents do not; at least none that I know of represent a significant financial risk. We have sent them into the mortgage financing subsidiary, the consumer financing subsidiary. We are training our examiners to understand those activities better. We are even training them in the penalties we want to use if they go in and find something they do not like. We are learning our way through this. We have not examined nonbanks before. We are going back and setting performance standards for those groups, and since the Congress gave us cease-and-desist authority over the bank holding companies and affiliates, over a year ago, we are preparing to use that authority and are training our examiners in our schools to use cease-and-desist authority. We have used that cease-and-desist authority. We have actually put it in place under the law four times in the last year since we have had it. We are all ready to use it four more times. Either the decision is not made yet, or the banker has said, I agree; I will go along by agreement.

We are trying to build an oversight and correction procedure into the nonbank areas. We are not trying to treat them as if they were banks. We are not trying to keep them as constrained, as reviewed, as

scrutinized, as one would do if they were running a bank, all of whose deposits are payable on demand and subject to insurance. We are feeling our way to find out how much oversight is necessary for those operations to protect the integrity of the banking sector, of which they are an affiliate.

Mr. ST GERMAIN. We talked earlier about the fact you said you are putting on more examiners.

Mr. HOLLAND. Yes.

Mr. ST GERMAIN. Of course, if you approve many more activities that are related to banking, for bank holding companies, that means more examiners, because you have to train examiners about these businesses?

Hr. HOLLAND. That is painfully true.

Mr. ST GERMAIN. I hope you keep that in mind when you are reviewing these applications for new activities.

Mr. HOLLAND. A point well taken.

Mr. ST GERMAIN. On page 35, you discuss the regulatory proposals. We touched on that subject a little earlier, and the fact that you discussed it with other bank regulatory agencies. Have you included the Home Loan Bank Board and the NCUA in these discussions?

Mr. HOLLAND. No. We thought it best to aim at bank examinations and bank regulation problems first. Where we have our problems of communication and uniformity, of working together, is on failing banks, and problem banks, and the like. And we are not that closely related or familiar with the kind of examinations that are being done with S. & L.'s and credit unions.

However, I can certainly see that there would be value in an exchange.

Mr. ST GERMAIN. You are aware of the fact the Federal Home Loan Bank Board does have an intense interest in some changes in the supervisory act and the holding company provisions?

Mr. HOLLAND. Yes.

Mr. ST GERMAIN. I was in the conference that gave those cease-and-desist problems, as you recall. We did not grant them to the Home Loan Bank Board because we did not have enough information. We will be reviewing that. Certainly, that was an indication of the concern. So I would be hopeful that you might include them in your colloquy.

You know, on page 54, you mention, in the last paragraph, "recent experience also demonstrates that some weakness exists in enforcement procedures." I think a classic example of that is U.S. National in San Diego.

Mr. HOLLAND. So do I.

Mr. ST GERMAIN. Incidentally, with respect to your legislation, and you mention on page 41, bringing foreign banks under holding company provisions, why do you think they should be brought under the bank holding company provisions, rather than requesting to be members of the Fed?

Mr. HOLLAND. The bank holding provisions give us some control over the activities that they get into in this country. It does not give us the kind of supervisory or monetary control that comes with meeting Federal Reserve requirements, being subject to regulation Q rates, in-

terest rates ceilings, and the other constraints that focus on the bank. And those were important in our minds. That is why we chose that recommendation.

Mr. ST GERMAIN. In order that they come under the bank holding company provisions?

Mr. HOLLAND. If they are only under the bank holding company provisions, and not members of the Federal Reserve, they would not be required to meet Federal Reserve requirements. They would not be required to meet interest rate ceiling requirements, regulation Q requirements. They would not be subject to the kind of examination and the other kinds of limits and constraints that are attached to a bank that is being supervised by the Federal Reserve, or for that matter, by any other Federal bank examination agency.

Mr. ST GERMAIN. Let us try to do this. My understanding is the legislation would require that these foreign banks come under the bank holding company provisions?

Hr. HOLLAND. Yes.

Mr. ST GERMAIN. What if they were to come under the provisions applicable to member banks of the Federal Reserve, then there would be more supervision and authority over them than there would be under the holding company regulations; would there not?

Mr. HOLLAND. Yes, that is what I meant to be saying, Mr. Chairman.

Mr. ST GERMAIN. I am asking you why you would go the bank holding company route, rather than the other route.

Mr. HOLLAND. We asked for both applying the bank holding company act to them and applying the Federal Reserve membership to them. We want them to be subject to both nets of Federal regulations.

Mr. ST GERMAIN. Then they would be subject to regulation Q, your examination procedures?

Mr. HOLLAND. In addition, they would be subject to the provisions that the bank holding company regulations imposed on them.

Mr. ST GERMAIN. If they were not bank holding companies, you would not be concerned with that problem, would you? If they were classified as banks, then they could not get into outside activities, and would be restricted to the same activities that our domestic banks are restricted to.

Mr. HOLLAND. It is not so much them as their affiliates, I think, that is the problem in this case. And we also have the interstate problem. I do not believe the Federal Reserve Act would do anything to their ability to acquire affiliates across State lines.

Mr. ST GERMAIN. It would not prohibit this?

Mr. HOLLAND. I do not believe so. I can give you a memo on that that narrows this down more precisely, if you would like. They are partly overlapping nets of regulations. You are quite right to suggest so.

Mr. ST GERMAIN. Earlier we talked about all the checks and balances that the Congress wisely applied to the Federal Reserve Board. I have been here since 1961, and frankly, I do not even know where the Federal Reserve Board is.

Mr. HOLLAND. We have to invite you over there for lunch.

Mr. ST GERMAIN. I do not accept lunches. I will join you in the Rayburn cafeteria.

The point is, that, under both William McChesley Martin, and now, Arthur Burns, I have always had the impression that both of these gentlemen were very happy to sit down and listen to everbody, and that when the chairman spoke, the members were prone to listen very carefully. Am I wrong?

Mr. HOLLAND. I think you have chosen your words very wisely. We listen very carefully. That is something different than saluting and saying, yes, sir. There are seven men on the Board. Everyone has to vote his own conscience and conviction. Both Chairman Martin and Chairman Burns have been men with very keen insight into problems; the rest of us listen, but we occasionally vote against them.

Mr. ST GERMAIN. I must admit that I have found that they are very strong personalities. Let us say, they are comparable to C. Arnholt Smith, although their motivations are different, and their modus operandi is different. I found both of them have been very dominant personalities, dominant because of their experience, their backgrounds, and their keen insight. I mean this in a very complimentary fashion. I am not being at all sarcastic here. I think both of these men were well chosen.

I have not always agreed with them. For instance, an example would be a letter I recently received from Chairman Burns on the question of IRA differential. We can disagree and be agreeable, yet I can have a lot of respect and admiration for him. I agree there are checks and balances that appear to exist, and probably do exist. These checks are pretty well set to policy. You note a change when a Chairman changes.

Mr. HOLLAND. It is a little hard to read this from the record. I could just say you could look and see how many times there are dissenting votes on the Board, and the Federal Open Market Committee, opposite to the side on which the Chairman is voting, to give you a sense there are individuals that vote their minds. I would be surprised if there was not a time when every other member of the Board has been on the opposite side of the fence, and recorded a dissenting position from the Chairman.

The thing that is a little hard to explain is that the Chairman is not often in the minority. That is partly because he usually has good arguments. It is also partly because both of them—I have watched both men operate as Chairman—both of them feel very keenly the sort of corporate responsibility that the position of Chairman conveys. That means the need to develop a consensus of a majority vote of the collective body sitting there. Time after time, I have sat and watched the two of them, Martin in his years and Burns now in his years, go around the table, listen to arguments, encourage one person to argue with another, to argue back and forth themselves. Where can we find consensus, and push and push and feel, until finally we develop a clear majority of the Board or the Open Market Committee, whichever group it is, for a particular policy.

Then very often, almost always, he will cast his vote with that consensus. A lot of it is the exercise of the chairmanship.

You, indeed, must surely have the same kind of experience.

Mr. ST GERMAIN. I wish I could be as successful. On that issue I quoted Chairman Burns' speech of October 1974, and noted, that

there were three other members who spoke in similar terms. Yet when I read your testimony yesterday, I realize that somebody else must have been a little more domineering there.

Mr. HOLLAND. We were going off in different directions, speaking individual minds, partly in advance, in anticipation of what the evidence might show. And as the evidence developed, the different views shook down a little bit. Some of the areas we were most concerned with, we found other ways of handling. Then in the end, we had to face the fact that we needed to find a position that a majority of our organization could come to the Congress and say, this we are for. This is what we think would be helpful.

You will notice at several points my testimony says, a majority of the Board favors this. That will show you where we do not have unanimity. It is a majority that has this view. We do record it as a useful step forward.

Moreover, there have been changes since last October not only in the individual people who spoke then and what they say now, and the piles of paper like this that represent the studies we have done, but also in the way the banks and bank customers themselves are behaving. This experience in 1974 has markedly altered in a more conservative direction, in a more prudential direction——

Mr. ST GERMAIN. I remember that word prudential.

Mr. HOLLAND. In that very way the banking system has done a lot of self-adjusting. It paid a pretty expensive tuition for a course in the prudent limits for banking. Banks all over the country now have adjusted themselves—we find it time after time when our examiners go in—to a more prudent policy, to be more careful, to work harder. That is one of the reasons it does not look like we need as radical a change as some thought at the top of Federal supervision.

We do not have a recalcitrant, exposed, aggressive, overdriving banking system as some comments over the past year would have suggested. It is a changed group.

Mr. ST GERMAIN. On the issue of domestic banks that open branches in foreign countries. Say I am an average size or small banker and I have heard some of my fellow bankers talking about their success that they have met with opening foreign branches, and I decide I am going to do the same. What are the criteria applied to determine whether or not a domestic bank would be allowed to open a foreign branch or establish a foreign branch?

Mr. HOLLAND. Any domestic bank that is going to do that has to get two kinds of approval. If the bank is a member bank, it has to get the Board's approval. And also approval of the appropriate authority of the country which it is entering.

Mr. ST GERMAIN. Let us talk about your approval domestically.

Mr. HOLLAND. Those applications vary greatly. They are hard to generalize. But let's take the example of a bank seeking to establish its first foreign branch. There are a number of questions we would ask. Has a meaningful foreign market been identified and researched? Does it look like the projected scale of operations is reasonable in relation to the bank and the market? Does it look like the bank has good, well-trained people lined up to run the branch, so that there would not be amateurs trying to run a foreign operation? Does the bank have

enough capital itself, so that its own organization is strong; also can the bank put enough capital behind the liabilities of the foreign operation so that it is well defended? Does the bank have, at home, the kind of knowledgeable people in the field of international finance, and a top management that understands enough the risk that they are getting into and attention that that area needs? If the answers to all those are yes, I think we would be inclined to say, fine, go ahead.

Mr. ST GERMAIN. Your first point was meaningful market?

Mr. HOLLAND. Yes.

Mr. ST GERMAIN. Would you define that for me?

Mr. HOLLAND. We would feel much more inclined to approve a branch if the fellow was going over to a foreign country to merchandise the kind of banking services that it seemed clear that the people in the country are ready to buy, and he has a location in the city that looks unreasonable. If he is going to try to take a banking service abroad that fits here but that does not appear to fit a foreign market, we would regard that as an indication that he is not informed about the kind of business he is getting into, and as an argument for being slow to approve his foreign branch.

Mr. ST GERMAIN. With respect to our foreign branches—are they investing capital in the foreign countries, are they accepting deposits, or are they bringing in deposits that they reinvest in those countries, or is it some of both?

Mr. HOLLAND. It depends. For the most part, most foreign branches bring in money from elsewhere, that is either from the parent, the head office in the United States, from the deposit raising structure of the head office here in the United States, or they buy it from the Eurodollar market in the international money market. That is almost always how they get started. It is only over time, and with some real work that a foreign branch can develop local deposits from the small businesses and the average man on the street in foreign countries. That is a slow business to develop. Many of our foreign branches do not try to do that. They remain wholesale branches. They deal with business, finance, and money brought in from the international market.

Mr. ST GERMAIN. Therefore, this is comparable to the whole story about capital surplus and capital short areas?

Mr. HOLLAND. Yes.

Mr. ST GERMAIN. When we experience periods of disintermediation here, is there any restraint? Do the facts suggest that there be a little restraint in the movement of our funds, since we no longer have a surplus here?

Mr. HOLLAND. In the days that we had a voluntary foreign credit restraint program as a part of a quasi-control program a few years ago, we were suggesting that to our banks—hold down, limit the amount of money you lend abroad. Now, that program is dissembled, and we are back to a free decision on the part of our bankers as to where they move and invest their money.

In point of fact, there is a tendency for our banks with branches abroad, when monetary policy tightens here, for them to borrow more money in the international money markets, and bring it back to the head office. And we have dealt with that in various ways over the years, with regulations.

Mr. ST GERMAIN. That is usually pretty expensive money, is it not?

Mr. HOLLAND. Very often. We dealt with it two ways. There was a time when we tried to rule it out, with regulation Q ceilings. Another time, more recently, what we did is put reserve requirements on it. If they are going to bring it back here to do the work of domestic money, we put reserve requirements on it when it comes back.

Mr. ST GERMAIN. You noted on the one hand that there is approval here, and there has to be an approval by the foreign country. In your experience, does it oftentimes happen that, when an application is submitted and approved here, that it is denied by the foreign country in which the branches are to be established?

Mr. HOLLAND. The inclinations are not usually that way. The way the bank does it is usually the other way around. The bank would usually try to get its foreign approval lined up before it comes to us for our approval, and the question we will ask before we act on it is, If this is approved, is it acceptable to the foreign authority? They may not have all of the names signed on the dotted line, but there will have been enough discussion so that they will know how they are going to be received in the foreign country.

Mr. ST GERMAIN. By now, you must have digested your lunch.

Mr. HOLLAND. I have; thank you, sir.

Mr. ST GERMAIN. Rather than stay on, as we have had other witnesses stay on, beyond the dinner period, we would like to ask you if you would be receptive to answering any questions that would be submitted in writing for the record?

Mr. HOLLAND. I would be glad to do that. We want to work with this subcommittee, Mr. Chairman. We see where you are going, and we want to be helpful. We want to be a part of your studies, and I will try to be as forthcoming as I can.

[The information is contained in the Fed's response the subcommittee dated September 8, 1975, and may be found in appendix A.]

Mr. ST GERMAIN. May I say this subcommittee has embarked upon a very extensive, ambitious project. We are hopeful that we can come up with some legislation that is going to be beneficial to the financial community, we intend to come up with some changes and reforms that are consumer oriented, that come from the customer, those who use and need the services of our financial institutions, the commercials, the thrift institutions, and the credit unions.

I think that if we can do something like that, we will have reached a turning point, and it will be for the benefit of the financial institutions, because we will be able to go to all the people and say, look, at long last, we have enacted legislation that is going to benefit you. It is going to assure you that your financial institution is safe and sound, that it is doing the job that it should be doing. Hopefully, we will return to you a higher rate of return on the money, not for the people who can afford to put in $100,000 or $50,000, but to the people who are putting in $2,000, $5,000, $10,000, and for the people who want to purchase a home.

We want to insure that the thrift institutions, as now created, are able to provide mortgage money for the average workingman. How can we do this? Certainly, you at the Fed can be helpful to us. We are going to send questions out to the supervisory agencies, to the Fed,

asking them to help us resolve some of the existing problems that we see, so that the thrift institutions serve the needs of the country.

And that is why we are happy to work with you. I hope that during the questioning today—some of them may have been hard questions, but they are just for the purposes of getting this record down, so that we know where we are going, and we can submit it to the full committee later on, for the benefit, as I say, of the financial institutions, and the financial community, as well as to the people it serves.

Once again, just as on your previous appearances here, I want to thank you for your graciousness and your responsiveness. As usual, you have been very frank and open, and it has been very enjoyable for the chairman and the members of the subcommittee, who have been in and out. I think you have noticed there has been great participation. That is a tribute to you.

Mr. HOLLAND. I am always glad to come. I enjoy these experiences, and I feel that I am talking to people who are going to make the country better, by putting their shoulders to the wheel.

Mr. ST GERMAIN. We are working together.

The subcommittee will be in recess until 10 tomorrow morning, at which time we will hear from the Comptroller of the Currency, Mr. Smith.

[The prepared statement of Governor Holland follows on page 297.]

[Whereupon, at 5:15 p.m., the subcommittee recessed to reconvene at 10 a.m. Thursday, July 17, 1975.]

Statement by

Robert C. Holland

Member, Board of Governors of the Federal Reserve System

before the

Subcommittee on Financial Institutions Supervision,

Regulation and Insurance

of the

House Committee on Banking, Currency and Housing

July 16, 1975

I am pleased to appear before this Subcommittee, on behalf of the Board of Governors of the Federal Reserve System, to discuss the broad range of important banking regulatory and supervisory matters concerning which your distinguished Chairman has requested the Board's views.

The financial experiences of the last two years have raised many significant issues with regard to the regulation and supervision of the nation's banking institutions. The need for a careful review of those factors that might adversely affect the stability of the banking industry has been recognized by this Subcommittee and other committees of the Congress, by the Board, and by the other banking regulatory agencies. As I reported to this Subcommittee in my testimony of December 12, 1974, at the Board we have undertaken a careful analysis of the key problem areas that might tend to contribute to an undesirable degree of instability within the banking system and of steps that might be taken to reduce such proclivities. A number of our colleagues in Government

have been engaged in similar efforts as well. Many bank managements have also been thinking through the implications of recent financial events for their own institutions. This degree of attention and concern regarding the health of our banking system attests to the critical role banking institutions fill in our financial system and economy, and it underlines the need to insure that no significant weaknesses impair their continued well-being.

Among those financial events of recent years that have given cause for concern, the failure of the Franklin National Bank looms large. The circumstances leading to the demise of that institution have already been publicly reported, and therefore my statements on this matter will focus primarily on the role played by the Federal Reserve in cooperation with the other bank regulatory agencies.

During the period from mid-May to October of last year, the Federal Reserve Bank of New York

provided emergency credit assistance to Franklin National Bank in amounts rising to a peak total of $1,767 million. The actual amounts loaned to Franklin varied from day to day, depending upon its liquidity needs. The Franklin National Bank was a member bank of the Federal Reserve System; as such, it merited the privilege of accommodation at our discount window under the usual rules so long as it remained solvent, and we were advised by its primary bank supervisor that such was the case. The sheer size of the loans to Franklin, however, was extraordinary.

The primary purpose of these loans to Franklin was to prevent the immediate or imminent closing of that institution because of its liquidity problems. We believed that the closing of a $5 billion bank such as Franklin could have precipitated other bank failures with resulting large losses for many individuals and businessmen and for the Federal Deposit Insurance Corporation. This situation arose during a difficult period for financial institutions and financial markets; such a failure at that time could, in our judgment,

have had serious adverse consequences for the stability of our nation's banking system, and for domestic and international financial markets in general.

With these considerations in mind, Federal Reserve credit, fully secured by Franklin National Bank collateral, was extended to Franklin to help offset the massive net withdrawals of funds that developed as that bank's difficulties became generally known. Between May 8 and October 8, 1974, when the bank was declared insolvent, it suffered an outflow of funds amounting to $2.8 billion -- over half its total footings. By strenuous efforts, the bank succeeded in reducing its loans, investments and cash by $1.1 billion during this interval. The eventual $1.7 billion in Federal Reserve credit assistance was necessary to offset the balance of the outflow.

During this five-month period, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Board of Governors, together with the Federal Reserve Bank of New York, were in frequent communication with each other in a joint effort to arrive at a permanent solution to Franklin's difficulties. As you know, the Comptroller has the statutory responsibility of determining whether or not a national bank is insolvent. Upon such a determination of insolvency, the FDIC must be appointed as receiver. The FDIC then proceeds with the winding-up of the bank's affairs, seeking to achieve an orderly transfer of the insolvent institution's assets and liabilities and as little loss as possible to the deposit insurance fund it administers.

In the Franklin case, the Comptroller began consultations in May and June with major banks that might have been capable of, and interested in, acquiring Franklin by merger. In September he obtained the additional advice of a financial consultant in an effort to determine definitely whether the bank could continue as a viable, independent institution.

In July, foreseeing the possibility that Franklin might have to be declared insolvent, the Comptroller requested the FDIC to contact other banking organizations which were potential purchasers of Franklin's assets and to develop a plan to assist such a purchasing bank in a transfer of assets and liabilities. The FDIC accordingly began negotiations with interested banks to draft an acquisition proposal upon which banks could bid competitively in the event Franklin had to be declared insolvent. Briefly, this plan, as it was developed, called for the FDIC as receiver of Franklin to transfer all of Franklin's deposits and certain other liabilities to an assuming bank; that bank would be allowed to select assets of Franklin up to an amount which, when added to the purchase price bid, would equal the liabilities it assumed. The assuming bank would be required to keep most of Franklin's offices open for at least 30 days. On its part, the FDIC would: (1) indemnify the assuming bank against losses from unassumed liabilities;

(2) advance supporting capital to the bank in the form of a subordinated note; and (3) in return for the New York Reserve Bank surrendering its lien on the assets of Franklin that were transferred to the assuming bank, assume Franklin's obligations to the New York Reserve Bank, which would be repaid to the extent possible out of the remaining assets, but would in any event be fully repaid within three years whether or not sufficient collections had been made at that time. This last provision assured that no loss would be incurred by the Federal Reserve System as a result of either its emergency lending to Franklin or the purchase by the New York Reserve Bank of Franklin's foreign exchange contracts. This latter purchase had been undertaken by the Federal Reserve on September 24, 1974, in order to forestall possible defaults on these contracts that could have further seriously weakened confidence in foreign exchange markets, which at that time had already been shaken by defaults by a well-known German bank and by a succession of public disclosures of

foreign exchange losses by Franklin and other banks throughout the world.

During the summer, one after another possibility that would have permitted Franklin National to continue as an independent institution was investigated. By October 8, 1974, every reasonable prospect of that kind had been explored and found inadequate. The Federal Reserve's loan had served its purpose of enabling Franklin to meet its day-to-day liquidity needs up to that point, but the total was approaching the limit of available collateral. The FDIC's plan for the transfer of Franklin assets and liabilities was ready. In those circumstances, the Comptroller declared the bank insolvent.[1/] The FDIC as receiver thereupon proceeded to implement its plan. The outcome of its negotiations with possible purchasing institutions was that European-American Bank and Trust Company purchased assets and assumed certain liabilities of Franklin National.

1/ For a more detailed explanation of this action, see the Affidavit dated October 8, 1974 filed by the Comptroller of the Currency in the U.S. District Court of the Eastern District of New York concerning the matter of the liquidation of Franklin National Bank.

An orderly transition has followed, although it will be some time before all aspects of this transition will be finally completed. While in the end Franklin can be said to have failed, the provision for the uninterrupted continuation of its banking services through a successor institution minimized adverse repercussions.

Cooperation among the Federal bank regulatory agencies, combined with consultation with the Treasury and the New York State Banking Department, was instrumental in producing the results I have outlined. Each agency had a distinctive role to play, and each role generated its own concerns. We at the Federal Reserve were expecially interested in the adverse market attitudes and questions about banking soundness that were being generated as the Franklin case dragged on. We were concerned as to Franklin's vulnerability to any new shock that might come along. And we had a painful awareness of how Franklin's debt to the Federal Reserve kept climbing closer to the probable maximum

loan value of the acceptable collateral which the bank could provide. For those reasons we at the Federal Reserve urged that remedial measures move forward as promptly as they could. The Comptroller and the FDIC, respectively, with their own statutory obligations to consider, had to effectively exhaust alternative solutions short of receivership and to document liabilities and minimize losses insofar as time and circumstances permitted. It should not be surprising that on occasions during those months the agencies found that their preferred priorities for actions differed. When such instances became significant, however, hard work and good will overcame them. Fortunately, no new external shocks developed, and by the time Franklin was determined to be insolvent a detailed and well-integrated plan for its succession unfolded effectively. As nearly as can be judged at this stage, not a cent of depositors' or taxpayers' money is expected to be lost in the process.

Although the Franklin National case was concluded successfully, experience made it clear that increased attention needed to be paid to stronger preventive and follow-up measures to reduce the possibility of similar situations arising. Accordingly, the Federal Reserve System strengthened its program covering banks under its jurisdiction to place increased emphasis on the identification, surveillance and timely resolution of current and potential problem bank cases. This action had first priority among the broad sweep of studies addressing key problem areas in banking supervision and regulation that I described in my testimony before this Subcommittee last December 12, and about which I will be reporting to you later in my testimony today.

Briefly, each Reserve Bank was asked, among other actions, to make special efforts to identify member banks in its district which were or might be facing difficulties with regard to the quality of

their assets or the balancing of financing needs with the prospective availability of funds. Second, with respect to State member banks, a greater than usual concentration of Federal Reserve examiner time and attention was to be devoted to identified problem banks during the remainder of 1974 and also through the year 1975. In each such problem bank case, an appropriate and specific program for remedying its difficulties was to be established, including if need be direct discussions with the bank's directors to confirm the commitment of top management to that task. Third, any member banks experiencing unusual liquidity difficulties because of a runoff of money market funds or because of public concern about the condition of the banks were to be informed of the basis on which accommodation at the discount window would be made available.

The Federal Reserve has thus taken requisite administrative steps to insure that greater emphasis is placed on identifying, monitoring and following up

problem bank situations. It is humanly impossible -- and even undesirable -- for supervisors to prevent all bank problems; but it is practical to aspire, as we do, to recognizing problems early and moving promptly to try to remedy them. There remains, however, a gap in the range of feasible remedial actions that could be undertaken if preventive measures should somehow not succeed in forestalling a bank failure. In that eventuality, the most desirable ultimate action in most cases is for the bank to be taken over by another bank. Bank mergers, where permitted by State branching laws, can sometimes serve this purpose effectively. The alternative of bank holding company acquisition of a failing bank, however, even where permitted by State laws, is substantially inhibited by two Federal statutory constraints. One enforces certain time delays in the approval and consummation of all bank holding company acquisitions. The second effectively prevents any holding company acquisition of banks across State lines.

In our view, either or both of those limitations can interfere with actions needed to protect the public interest in some cases. Accordingly, the Board has recommended to the Congress substantive statutory changes, now embodied in H.R. 4008.

The first recommendation involves procedural amendments to the Bank Holding Company Act designed to permit the immediate or expeditious consummation of a transaction under that Act in certain problem bank and bank holding company situations. The second recommendation would amend the Act to grant the Board authority to approve an acquisition of a bank across State lines by a bank holding company, when the Board determines that a large bank, or a bank holding company controlling a large bank, is in severe financial difficulty, and the public interest would best be served if the bank involved were acquired by an out-of-State holding company. I will discuss each of these recommendations in turn, referring to the current law, the main reason therefore,

the key arguments for changing the law at this time, and the Board's reasons for recommending the specific amendments proposed in H.R. 4008.

Certain time schedules for the provision of notice and hearing 2/ were enacted as part of the original Bank Holding Company Act of 1956, as a compromise between giving bank chartering authorities an absolute right to deny a holding company application to acquire a bank and giving such authorities only an informal consulting role vis-a-vis the Board's final decision in the case.

2/ Under existing law, the Board, before approving an application for the acquisition of voting shares or assets of a bank under section 3 of the Bank Holding Company Act, must: (1) give notice to the Comptroller of the Currency if the applicant or bank involved is a national or district bank or to the appropriate State supervisory authority if the applicant or bank involved is a State bank; (2) allow thirty days within which the views and recommendations of the Comptroller of the Currency or the State supervisory authority, as the case may be, may be submitted; and (3) if the supervisory authority so notified files a written disapproval of the application within the thirty-day period, the Board must provide a hearing on the application, and base its decision on the record of that hearing.

The Board in section 1(1) of H.R. 4008 has recommended, first, that the regular thirty-day notice period be shortened to ten days if the Board advises the supervisory authority that an emergency exists requiring expeditious action. Secondly, section 1(1) as proposed would give the Board the authority to waive notice and hearing requirements entirely if the Board finds that it must act immediately on an application to prevent the probable failure of a bank or bank holding company involved in the proposed transaction.3/ Both of these suggested amendments parallel provisions subsequently enacted in the Bank Merger Act -- provisions which have worked well in the nearly fifty instances in which they have been used over the past ten years.

3/ The Board's staff has noted that there apparently was an inadvertent omission in the printing of H.R. 4008 and H.R. 5331, as the bills provide that notice and hearing requirements may be dispensed with if the Board finds that it must act immediately "to prevent the probable failure of a bank holding company" involved in the transaction. This provision should read "to prevent the probable failure of a bank or bank holding company" involved in the transaction. Thus, it is recommended that page 3, line 17 of H.R. 5331 and page 3, line 11 of H.R. 4008 be amended by inserting "bank or" before "bank holding company" in each such line.

In the Board's judgment, the present requirement for thirty-day notice to the relevant bank supervisor is both burdensome and unnecessary in the context of a problem bank or bank holding company situation where the public interest requires immediate or expeditious action. From a practical standpoint, the primary supervisory authority in such a situation would be actively involved in the process of screening potential acquirers and would also be desirous of having an acquisition quickly consummated. Similarly, the protracted hearing requirements in the case of recommended disapprovals by the supervisory authority are ill-suited to a failing bank or bank holding company situation where the public interest demands that decisions be made quickly on the basis of available evidence.

There is an additional statutory delay to be dealt with. Under existing law, the Board must immediately notify the Attorney General of any approval of a proposed bank acquisition, merger or consolidation transaction under section 3 of the Bank Holding Company

Act, and such transaction may not be consummated before the thirtieth calendar day after the date of approval by the Board.

This requirement was added to the Bank Holding Company Act in 1966 in order to conform with the standard consummation procedures being established in the Bank Merger Act. The purpose of the provision was to eliminate conflicts between the Board's decisions under the Bank Holding Company Act and the Attorney General's enforcement of the antitrust laws, which might otherwise require the unwinding of a transaction after that transaction had been approved under the Bank Holding Company Act.

However, the Bank Merger Act provides for an exception to this delay in problem cases, while the Bank Holding Company Act does not. The Board is recommending that, in cases involving problem banks or bank holding companies, the consummation procedures of the Bank Holding Company Act be fully conformed to those in the Bank Merger Act.

Accordingly, it is proposed that, when the Board has advised a supervisory authority of an emergency requiring expeditious action, consummation be permitted five calendar days after the date of approval. In cases where the Board has found that it must act immediately to prevent the probable failure of a bank or bank holding company, it is recommended that immediate consummation be permitted. In the Board's judgment, there appears to be no public policy reason for not having parallel consummation procedures for bank mergers and bank holding company acquisitions in problem bank situations, since the same reasons exist for not waiting thirty days for the Attorney General's competitive judgment in both cases. As a practical matter, the Federal banking agencies in such situations have regularly followed the practice of informally consulting with the Attorney General in advance in any case large enough to raise substantial competitive questions.

By effectively eliminating bank holding companies from bidding in emergency bank situations, the existing statutory delay provisions in the Bank Holding Company Act have unnecessarily limited

the number of potential acquirers of a problem bank. This can increase the anti-competitive risks in such acquisitions by often limiting the pool of potential acquirers to banks already in direct competition with the problem bank, e.g., in the case of Franklin National Bank, other New York City banks. The holding company can be a pro-competitive form of bank expansion, and its use should not be effectively foreclosed in infrequent problem bank situations because of delay requirements not similarly imposed in bank mergers. Waiver of the usual delay provisions undoubtedly would be warranted in only a small number of cases, and in those cases the waiver should produce net public benefits.

Another -- and more sensitive -- constraint on bank holding company acquisitions is geographical in nature. Under the Bank Holding Company Act, the Board may not approve any further acquisition of a bank by a bank holding company across State lines.[4/] This provision was made part of the

4/ The precise words of section 3(d) provide that the Board may not approve any application under section 3 of the Bank Holding Company Act: ". . . which will permit any bank holding company or any subsidiary thereof to acquire, directly or indirectly, any voting shares of, interest in, or all or substantially all of the assets of an additional bank located outside of the State in which the operations of such bank holding company's banking subsidiaries were principally conducted on July 1, 1966, or the date on which such company became a bank holding company whichever is later."

original Bank Holding Company Act of 1956 in order to halt the further expansion of several large multi-State bank holding companies then in existence. It was based in large part on Congress' concern that, unless this trend were halted, widespread and frequent acquisitions by major bank holding companies could eventually lead to an undue concentration of banking resources in the United States. In particular, it was thought that, absent this provision, holding companies would be used to avoid the multi-State branching provisions of the McFadden Act, and it thus was also intended to preserve the rights of the States in this area.5/

5/ Under the terms of this provision, a bank holding company can only acquire a bank outside of its principal State if the State in which such bank is located takes action to specifically permit such acquisition. If a State took such action, the Board would still have to decide the application under the statutory standards of the Bank Holding Company Act. At the time of this Act's passage in 1956, no State granted such permission. Except for Iowa, which has enacted a law giving a single grandfathered multi-State bank holding company permission to acquire additional banks in that State, and Maine, which recently enacted a law which would allow acquisition of a Maine bank by an out-of-State bank holding company if a Maine bank holding company is given reciprocal rights in that holding company's State, the situation remains essentially unchanged with no other States granting such permission.

The Board is of the opinion that section 3(d) could, in the case of a large problem bank or a problem bank holding company controlling a large bank, operate in contravention of both national and local interests. The limitation to in-State bidders may, in the case of a large problem bank, severely limit the number of potential acquirers and result in an increased concentration of banking resources within a State -- contrary to an intent of Congress in passing the Bank Holding Company Act. In most of our States, the number of locally-owned banks big and strong enough to absorb a large problem bank are very few. The only smaller banks strong enough to undertake such a venture may be those affiliated with powerful commercial or financial interests domiciled either in this country or abroad.

The problem created by the constraints imposed by section 3(d) has been sharpened as banks, particularly large banks, have moved increasingly from asset to liability management. This shift in emphasis has led

many larger institutions to search far afield for money market funds. While this has often been of considerable benefit to the customers and communities they have served -- particularly in those areas where widespread branching is not permitted and local deposit generation is thereby limited -- liability management has increased banks' exposure to the risks created by any substantial net outflow of such nonlocal and often volatile funds.

When adverse news triggers enough outflows of funds to significantly weaken a bank, it may become necessary in the public interest to fold it into a larger and stronger institution. As you know, this occurred in New York and California, where big in-State banks were available to acquire the problem banks involved. Had institutions of the size of Franklin National or U.S. National failed in many other States, however, no banks in those States would have been large enough to acquire them. In such circumstances, the need to be able to arrange acquisitions across State boundaries would become very real.

The Board therefore recommends several amendments to the Bank Holding Company Act designed to permit out-of-State acquisitions in certain emergency and failing bank situations involving a large bank or bank holding company controlling a large bank. Under section 1(3) of H.R. 4008 as proposed, the Board would have the authority to make exceptions to the multi-State prohibitions of section 3(d) whenever the Board finds that an emergency requiring expeditious action exists with respect to a bank or bank holding company, or that it must act immediately in order to prevent the probable failure of a bank or bank holding company. The proposed authority would be limited, however, to cases involving a bank having assets in excess of $500,000,000 or a bank holding company controlling a bank having assets in excess of $500,000,000. There are three basic reasons for limiting this authority to the case of a large bank or bank holding company controlling a large bank:

first, the failure of such an institution can have damaging effects in both national and international markets and on the national economy; secondly, there may be few, if any, prospective acquirers of such an institution within any State; and thirdly, the most likely in-State acquirers are likely to be institutions of comparable or greater size, which might often pose problems under the anti-trust laws and threaten an increased concentration of banking resources within the State.

The Board chose a $500,000,000 asset cut-off figure because it would cover major money-center and regional banks, whose failure might have an adverse effect on regional, national or even international financial markets, but yet would not be so extensive an exception as to create a potentially significant loophole to the multi-State prohibitions of the Act. Also, in cases involving smaller problem banks, local acquisitions where appropriate can be more readily arranged by the FDIC and State authorities than can transfers of the liabilities and assets of large institutions.

The choice of any cut-off figure involves various public policy considerations by the Congress. The Board stands ready to supply the Subcommittee with additional data on this issue if that would be helpful. On the basis of data prepared by the Board's staff, a $500,000,000 cut-off would cover not only the large money-center and regional banks but also, in most cases, the largest bank in any State.6/ From our analysis of cases in which emergency or failing bank procedures have been used under the Bank Merger Act, it appears only three banks acquired under immediate or expeditious action procedures have had assets in excess of $500,000,000 (Security National Bank of Long Island, Franklin National Bank of New York, and United States National Bank of San Diego). Thus, the Board anticipates that this

6/ From the Board's figures, it appears this asset cut-off would include some 210 commercial banks across the country, including the largest bank in 39 States and the District of Columbia, and the two largest banks in 35 States and the District of Columbia.

provision would be applicable in only a handful of cases where there may be significant effects upon the national and international economy.

Under section 1(3) of H.R. 4008, the Board could use this authority to approve a multi-State acquisition only when it finds, in weighing the statutory competitive and other factors, that the public interest would best be served if the bank or banks involved were acquired by an out-of-State bank holding company. The Board thus anticipates that this authority would rarely be used and only in cases presenting very special circumstances, such as those involving Franklin National Bank. In our view, these relatively rare situations would not contravene the central purpose of the multi-State prohibition of the Bank Holding Company Act, which was directed at preventing large concentrations of financial resources through frequent multi-State acquisitions of banking institutions.

The Board is sensitive to the fact that the prohibition on multi-State branching was designed to

prevent the evolution of a few large banking institutions. While there would be only a very limited number of instances in which the Board would consider making exceptions to section 3(d), the amending language could be narrowed even more than was originally suggested. A strict limit could be placed on the number of acquisitions any single bank holding company would be allowed to make under such an exception. This limit should be more than one, in order not to encourage potential bidders to wait until an ideal acquisition opportunity was presented, but it could be less than five, in order to forestall excessive expansions of financial power. In our view, this kind of limit would serve to preclude any possibility of undue concentration of economic resources being created through exceptions to section 3(d).7/

7/ As a corollary to its recommended amendment of section 3(d), the Board has felt it necessary to also recommend an amendment in section 2 of H.R. 4008 overriding certain provisions of State law in situations involving a problem bank or bank holding company where expeditious or immediate action is required.

Section 7 of the Bank Holding Company Act reserves to the States their rights to exercise such powers and jurisdiction which they now or in the future (Continued)

The distinguished Chairman of this Subcommittee has also introduced H.R. 5331, a bill which embodies

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7/(Continued) may have with respect to banks, bank holding companies, and subsidiaries thereof. In problem bank or bank holding company situations, the normal circumstances which may have led a State to enact a statute prohibiting the formation of bank holding companies within its borders or otherwise restricting the entry of out-of-State bank holding companies do not apply and therefore such provisions should not be controlling when the Board has approved such application under the immediate or expeditious action provisions recommended in H.R. 4008. In such cases, the national interest argues that Federal law be supreme. In practical terms, even though a State may favor an acquisition by an out-of-State holding company approved by the Board under its immediate or expeditious action provisions as an alternative to failure, it would probably be impossible either for a State legislature to enact in time any necessary amendments to its laws, or for a State court to interpret the terms of an unclear statute. The delays involved in trying to pursue either of the above courses of action could be crucial. Section 2 of H.R. 4008 would solve these problems by providing that in any case where the Board has approved an application under the immediate or expeditious action provisions of H.R. 4008, the holding company may acquire and operate the bank involved as a subsidiary notwithstanding section 7 or any provision of State law which would otherwise prevent the acquisition or restrict the operations of that holding company.

Section 2, however, leaves intact State restrictions on multi-bank holding companies, so that an out-of-State bank holding company which acquired a bank with the Board's approval under the immediate or expeditious action provisions could not gain a competitive advantage over an in-State holding company by acquiring a second bank under those provisions. The McFadden Act restrictions on multi-State branching would not be affected by section 2 of H.R. 4008 as such restrictions are a matter of Federal law.

the Board's recommended procedural amendments to the Bank Holding Company Act, but which omits the recommended amendments to the multi-State prohibitions of the Bank Holding Company Act. I hope I have said enough here this morning to make clear why the Board believes that the public interest would best be served if the Congress enacted both the procedural and multi-State amendments suggested. We defer to the Congress on the question of whether these amendments might better move through the legislative process separately or linked together. We do believe that they can eliminate what might otherwise at some time prove to be a fatal constraint upon the regulators' ability to preserve a problem bank's services rather than to close it.

Having discussed the reasons why the Board believes that the proposals contained in H.R. 4008 would be particularly helpful to the Board in dealing with problem bank or bank holding company situations, I would like to proceed to comment on the other studies

that the Board has been conducting to develop better means for preventing such situations from occurring and resolving them as effectively as possible if they should arise. You may recall that in my testimony before this Subcommittee on December 12, 1974, I described the general scope of our efforts and the problem areas on which we were focusing our attention: the attenuation of bank capital produced by the rapid expansion of bank assets; bank liquidity problems, particularly heavy reliance on liability management, the consequent creation of highly interest-and-confidence-sensitive instruments, and the making of excessive loan commitments; a deterioration in the quality of bank assets; increased foreign exchange risks; and increased risk of losses in bond trading departments of banks. (A final problem area that I touched upon at that time related to the need for more expeditious resolution of problem bank cases, but I have already commented on that subject in my previous discussion of the proposals contained in H.R. 4008.)

The Board expects very shortly to place before the Congress several proposals for legislative action that are designed to equip us, and the other bank regulatory agencies, to accomplish better our goal of more effective prevention of potentially unsafe or unsound practices. These proposals are now in the final stages of discussion among the Board, the FDIC and the Comptroller of the Currency. I would like to outline the major ones briefly for this Subcommittee to give you a clearer sense of the thrust of our efforts.

The first of the proposals we expect to be bringing before you is directed primarily at strengthening the penalties in statutes imposing constraints on transactions among the banking subsidiaries of bank holding companies, their parent firms and other affiliates. It seeks through amendment of the Federal Reserve Act to subject member banks and their directors, officers and employees or agents to penalties for violations of, among other provisions, sections 22 (relating to transactions between member banks and their directors and loans to executive officers) and 23A (involving loans and investments in

affiliates). Another provision of this proposal would amend the Bank Holding Company Act to permit the Board to seek the imposition of civil penalties on companies or individuals that violate the Act. This provision would, we believe, increase significantly the deterrents to unlawful or unsafe transactions within bank holding companies.

A second proposal addresses the problem of possible misuse of bank assets by insiders. Under this proposal, section 22 of the Federal Reserve Act would be amended to aggregate loans by a member bank to an officer, director or significant stockholder and to any corporations which such person controls for purposes of applying legal lending limits. This proposal would limit the amount that could be loaned to all interests controlled by one individual to the same amount as could be loaned to that person alone.

A third proposal would strengthen the Board's authority to institute executive removal actions designed to prevent the continuation of unsafe and

unsound banking practices. Amendments would be made to section 8 of the Financial Institutions Supervisory Act to eliminate the current requirement that acts of personal dishonesty be involved before officers or directors of a banking institution can be removed by a bank regulatory authority. This change would permit such individuals to be removed for gross mismanagement in the form of practices that threaten substantial financial harm to the bank.

A fourth proposal would give the Board authority to order divestiture of subsidiaries of bank holding companies when continued ownership by a bank holding company constitutes a serious risk to the financial safety, soundness or stability of the bank holding company's subsidiary bank or banks. While such action by the Board would undoubtedly be taken only in the most serious situations, we believe the ability to require such divestitures is an important one for the Board to have. Its existence alone should serve as a strong deterrent to dangerously unsafe actions by bank holding company managements.

We believe that these proposals, and others that may be forthcoming as a result of discussions with our colleagues in the other Federal bank regulatory agencies, will be of substantial assistance to us in implementing a program of preventive measures that should prove extremely helpful in reducing the possibilities of future unsound banking practices.

The studies that the Board has been pursuing have produced not only the legislative proposals that I have described, but have also led us to undertake a series of administrative and regulatory actions, all designed to assist us in preventing troublesome situations from materializing in the key problem areas we have identified. The Board has thus taken steps within the scope of its current authority to detect potential banking problems at an early stage in their development.

One of the first of these actions I have already mentioned, namely, the step taken last fall to improve surveillance of troublesome bank cases.

A second step to promote early detection of such cases was taken earlier this year when an interagency early warning system was instituted by the Board in cooperation with the Federal and State banking supervisory agencies. This system has enabled all the relevant bank regulators to be promptly aware of any adverse findings uncovered in supervisory examinations of bank holding companies or the bank subsidiaries thereof.

In this same area of problem bank and bank holding company situations, the Board has formally adopted guidelines delineating a graduated range of alternative procedures to be implemented in correcting problem bank holding company cases. This step has served to set out clearly and systematically the corrective actions that the Board and the Reserve Banks had already begun to employ in remedying difficult cases.

In the area of foreign exchange operations at banks, we have recognized that floating exchange rates have increased the risk of potential losses (or gains) on a given size net open position in foreign currencies.

In addition, the danger of losses occurring as a result of poor judgment at the management level or as a result of unauthorized trading under inadequate internal controls probably increased with the growth in the worldwide volume of foreign exchange market transactions -- in which a growing number of U.S. banks participated.

To assess better the level of foreign exchange risks now faced by U.S. banks, a review has been conducted by the Board, in consultation with the Comptroller, of the operations of a sample of banks engaged in such activities. As a result of this survey, we have concluded that additional legislative authority is not required to improve the supervision of banks' foreign exchange operations. Steps have been taken to encourage banks, where necessary, to utilize more adequate internal audit and control procedures. Furthermore, because of the special vulnerability of foreign exchange activities, the Federal Reserve is working closely with the Comptroller to improve the surveillance of these bank operations, through

examinations and reporting systems. Perhaps the most encouraging information I can relay to you in this field, however, is the stream of reports we are receiving that bank managements of their own volition have sharply tightened their prudential controls over their foreign exchange departments.

Studies are continuing on methods of improving the entire range of bank examination practices and procedures, including the use of sophisticated reporting and management information systems to supplement the bank examination process. Work is going forward on means of detecting and limiting excessive loan commitments and other off-balance-sheet promises to lend which may expose banks to undue liquidity pressures. Still other work is focused on methods to detect and discipline poor quality bank loans more effectively. Ways are also being sought to better limit the level of risk exposure in banks' bond trading activities.

As I mentioned previously, the Board has been much concerned with problems associated with the attenuation of bank capital and pressures placed on bank liquidity. Additional work is therefore underway at the Board to develop better standards of what constitutes "adequate" liquidity, both for our own better guidance and that of member banks. The Board has also recently restructured reserve requirements on time deposits to encourage more prudent liquidity management at banks.

Earlier this month, the Board released for comment guidelines that we propose to apply in evaluating requests for approval of new subordinated debt issues by State member banks. These guidelines were issued in connection with proposed regulatory changes to permit greater flexibility by banks in the issuance of notes and debentures to bolster their capital structure.

We anticipate that application of these proposed criteria should tend to promote the practice by State member banks of issuing new debt on an adequate cushion of equity capital. The guidelines should also help to prevent banks from unduly concentrating their maturing

debt in any one year. In addition, these guidelines are intended to prevent the inclusion of terms in such debt issues that could be regarded as being in conflict with the public interest.

If we are successful in accomplishing those objectives with regard to issues of new subordinated debt by banks, we believe that the problems connected with the attenuation of bank capital that has been experienced over the past decade should be noticeably ameliorated.

I would also like to report briefly on the progress of the Board's efforts to improve bank holding company supervisory and regulatory policy over the longer run. I am pleased to say that considerable headway has been made in designing and moving to initial implementation of a more systematic analytical program to monitor bank holding companies' operations more closely. Reporting schedules have been developed to feed timely information covering the full range of bank holding companies' activities, including intra-company transactions, into a partially computer-based

analytical system which is being designed to focus immediate attention on potential problem situations as they evolve. The information capability the Board will possess once this work has been completed should improve our capacity to detect and correct bank holding companies' problems at an early stage of their development.

The Federal Reserve is also endeavoring to look more broadly at the bank holding company movement as it has unfolded from 1970 to 1975. We are trying to determine to what extent, if any, bank holding companies and their expansion into nonbanking areas may have contributed to financial strengths and financial difficulties. We expect that this effort will shed some useful light on a subject that has at times stimulated sharp divergences of views.

I should also note that the Board has reviewed the recent and prospective growth of foreign-owned banking operations in this country and their proper place in our structure of banking supervision. While I do not propose

to cover all the details of that complex subject today, I would point out the Board's conclusion that all banks, branches and agencies that are located in the United States but owned by foreign banking instituions would be most effectively and equitably regulated if they were brought under the provisions of the Bank Holding Company Act. The proposed legislation we have forwarded to the Congress in this area (H.R. 5617) contains provisions to this effect.

In looking back on this recent work the Board has done to strengthen our supervision and regulation of the nation's banking institutions, the need for a large number of changes -- some legislative, some regulatory, many administrative -- has become evident. Some of these needed changes have been minor, others have seemed sufficiently complex or significant to warrant taking the time of this Subcommittee to report. At this juncture in the history of our nation's banks, the severe pressures to which those institutions were recently subjected have been significantly reduced. We are now at a point where it is possible, as it was not then, to consider and to undertake a range of

prudent reforms to further strengthen our banking institutions and thereby to help insure the continued well-being of this country's vital banking system.

All the faults we have found were not in the banking system, however; we have found some shortcomings in ourselves as well. Focusing as we have on the key banking problem areas has also helped us to understand more clearly in what ways inadequacies in the structure of bank regulation itself may have contributed to the development of some of these problems.

When I testified before your Subcommittee last December, I mentioned then that the concluding project in the Federal Reserve studies would be possible reforms of the Federal bank supervisory agencies. In the light of the work just described which has been pursued in other areas, we have turned our attention within the Board to the structure of the Federal banking agencies. We are also consulting with other agencies on this subject.

As you might imagine, there have been a good many alternatives to be analyzed and many considerations to be explored. It might be informative to your Subcommittee if I were to summarize the more plausible and thought-provoking alternatives we have considered, and outline what seem to be the key advantages and disadvantages of each. One cautionary note is in order, however, before I proceed. In this delicate subject area, there are few points on which facts can prove that one view is right and another wrong. Most of the major questions are matters of judgment, usually involving speculation as to what might happen were things to be done differently. Sometimes these are judgments on which reasonable men can and do differ. I cannot eliminate that ambiguity; I can only report to you the judgments of the majority of the Board as plainly as I can.

At one end of the spectrum of alternatives that we considered was consolidation of all Federal supervisory and regulatory functions.

A number of advantages would undoubtedly accrue from an effective consolidated Federal bank supervisory agency. The principal benefits we perceive are the following:

(a) Such an agency would bring about uniformity in Federal regulation, supervision and examination of banks. In addition it would result in uniformity on decisions concerning merger and branching applications.

(b) Presumably such a consolidation would eliminate some duplication of efforts and lead to a more efficient use of supervisory and examination personnel. It would also remove any problems arising out of consultations between the agencies and resulting delays in decision-making.

(c) We also believe there could be advantages from the development of consistent data which would permit

fuller analysis of the banking industry as a whole and permit more prompt identification of developments which might affect the stability of the banking system.

(d) Finally, the consolidation of three Federal agencies into one would preclude the possibility of banks changing their organizational status in order to obtain more favorable treatment from a different Federal supervisor.

Objections to consolidation take several forms, such as:

(a) A single Federal supervisory agency would be very powerful, and might have a tendency to stultify the ability of commercial banks to adapt to changing circumstances or be inconsiderate of the equities of the parties affected by its rules. At the least, it would result in the

elimination of most of the checks and balances inherent in our present bank regulatory structure, which do limit the power of individual supervisors.

(b) One agency would not offer as great a possibility for experimentation and innovation in bank regulations and supervisory procedures as now exists when three agencies divide the Federal responsibilities.

(c) Changing from the present arrangement to a single Federal agency could produce some serious transitional problems, such as the possibility of losing some of the valuable experienced examination and supervisory personnel now in the individual agencies. Serious personnel problems could develop in meshing the three present Washington and field-based forces.

Particular problems are also presented in considering in which agency consolidation should take place. For example, a majority of the Federal Reserve Board would have some concern about consolidation in a new agency or one outside of the Federal Reserve System. The experiences of recent years have made members of the Federal Reserve Board particularly conscious of the importance of involvement in bank supervision and regulation in the consideration of monetary policy. We believe that the condition of the banking system and information about individual banks is an important input for monetary policy formulation which would be lost or substantially reduced if the Federal Reserve had no role in the regulation or examination functions.

On the other hand some in the System have reservations about the consolidation of these functions in the Federal Reserve Board. They are concerned that adding the responsibility for all

bank supervision and regulation to the existing Board responsibilities might detract from the time and attention given to the Board's primary responsibility, monetary policy.

At the other extreme, we considered retaining the present regulatory and supervisory system.

By and large the advantages and disadvantages of this alternative are the converse of those listed for consolidation. In summary, the present regulatory system permits more innovation and experimentation in new bank activities and supervisory procedures. Any adverse effects may be confined to one segment of banking during the experimentation period. If, however, the innovation is successful, the changes can then be adopted by the other agencies. Moreover, the agencies can voluntarily communicate and cooperate to the limits of their power and good will in an endeavor to formulate uniform policies and procedures and keep them consistent and up-to-date.

The disadvantages of the present system can be read in the number of occasions when voluntary cooperation among the agencies did not produce optimal results. Episodically over the years, voluntary cooperation has not been a sufficiently powerful incentive to consistently produce vigorous, timely Federal supervisory action that was in harmony with other supervisory policies and uniform across the Federal agencies. Moreover, the diffusion of authority among the agencies is great enough so that it is often hard to pick the agency or the officials to hold accountable for such shortfalls. In such an environment, supervisory innovations -- particularly those that pinch the subject banks -- can be inhibited if the banks that are adversely affected have another supervisory jurisdiction open to them.

A third alternative is to divide responsibility for Federal bank supervision and regulation between two agencies.

One possibility that has been advanced is that all Federal bank regulations should be placed in one agency and all Federal bank examination and enforcement procedures in a separate agency. Many of the advantages of complete consolidation -- such as uniformity, elimination of duplication, more efficient use of personnel, and elimination of the possibility of banks shopping among Federal supervisors -- could be accomplished by this change. At the same time, such a division would maintain some significant element of checks and balances in the field of bank regulation.

However, many of the disadvantages of consolidation would also be present, such as the danger of a single regulatory body becoming wedded to the past and reluctant to adapt to changing times. The possibility of curtailed experimentation in regulatory procedures and a possible erosion of some regulatory checks and balances would also

be present. In addition there is a serious risk that the separation of regulation from examination and enforcement would weaken the effectiveness of bank examinations and reduce cross-fertilization between functions. Such a division could detract from the stature of the field forces and hinder field examination efforts to resolve problems. Moreover, whereas some coordination and jurisdictional problems might be eliminated with this type of structure, it is certainly possible that other problems, perhaps more serious, would be created.

A fourth alternative I might mention is to provide for representation of the Board of Governors in an expanded Office of the Comptroller.

It is possible that improved coordination of key supervisory and regulatory programs could be obtained if the Comptroller's Office were converted to a board with one member being a Governor of the Federal Reserve. Direct Board representation in the

activities of the Comptroller offers some advantage, since all national banks under the supervision of the Comptroller are also member banks of the Federal Reserve System. Moreover, under present practices the Comptroller's examiners are responsible for enforcing numerous Federal Reserve regulations applicable to national banks. Conversion of the Comptroller's Office from a one-man to a Board operation would also provide the benefit of group decision-making and provide a balancing of viewpoints in the supervision of national banks.

However, the creation of a Board for the Comptroller's Office could well have the disadvantage of producing a less expeditious and less efficient operation -- a result which can often flow from administration by a committee.

A fifth possible alternative is increased and more structured coordination of examination functions.

Our review of the other projects undertaken by the Board's Committee on Bank Regulatory and Supervisory Policy has shown that one of the most important areas calling for attention is the problem of revising and updating examination and enforcement procedures. I understand that the Comptroller's studies have reached similar conclusions.

There is a need for more realism, consistency and uniformity in examination standards and procedures. We believe that there needs to be an increased emphasis given to more timely reports and information systems which would supplement the practice of on-site examinations.

Recent experience also demonstrates that some weakness exists in enforcement procedures. There needs to be more effective and consistent follow-up of examiners', and other supervisory, recommendations to banks, in order to assure that the banks take those actions necessary to correct the identified problems in reasonable time.

The resolution of these problems might be helped if each of the three Federal banking agencies were to delegate some specific decision-making authority in the field of examination procedures to a representative on a new interagency group, which might be designated the Federal Bank Examination Council. The Council might be composed of Board members or senior officials responsible for bank examination from each of the three banking regulatory agencies. That group would not supplant the present Interagency Coordinating Committee, which ought to continue to provide a forum for consultation on regulatory and policy questions affecting not only banks but nonbank thrift institutions as well. The distinctive features of a new Examination Council would be that its members would be assigned responsibility for particular areas of bank examination procedures, given decision-making power in those areas, and held accountable by their agencies for the development of suitable standards and practices in such areas.

A Council of this nature could foster greater uniformity and consistency in the modernization of numerous bank examination and enforcement activities without most of the disadvantages feared from complete consolidation. In addition, it would permit undertaking a limited and circumscribed consolidation effort promptly, on an experimental basis, with flexibility to allow for revisions that prove desirable.

To be sure, such a Bank Examination Council would have its disadvantages also. Because of its relatively narrow scope, a number of important issues in bank supervision would be beyond its ability to solve. Since it would derive its authority by delegation, there is the chance that its members would be diffident in their actions out of concern for possible termination of their delegated authority. There is also the possibility that its members might show less initiative in tackling problems than would an individual agency acting on its own.

As the Board of Governors has reviewed all these alternatives, and the situations to which they are addressed, a majority of the Board has come to the following tentative conclusions on this subject.

First, some change in the present structuring of Federal bank supervision is desirable, although not essential. Federal bank supervision has done many things right, and it is not so flawed as to necessarily thwart key objectives of public policy in this field. On the other hand, the present diffusion of authority and responsibility among three Federal agencies is conducive to some confusion, uncoordinated initiatives, occasional delays and misunderstandings, and sometimes a subtle competition to relax or forego appropriate constraints on banking institutions. What is called for is measured action that ameliorates these weaknesses without sapping the strengths of the present agency structure.

Second, the Federal Reserve, as the nation's central bank, needs to be involved in the process of

bank regulation and supervision. Now, more than ever before, the Fed's key roles as monetary policy-maker and as lender of last resort reach into territory conditioned by prevailing bank supervisory and regulatory policies. Each of those sets of public policies increasingly affects the effectiveness of the other. Their close coordination is much to be desired.

Third, an appropriate step forward in the Federal bank supervisory structure at this time would be the establishment by the agencies of a Federal Bank Examination Council along the lines described above. It is, as I have said, an experimental and evolutionary idea, rather than a radical and irreversible one -- and the Board believes the former rather than the latter is what is called for today.

The Board is prepared to delegate selected decision-making authority in the field of bank examination procedures to our representative on

such a Council forthwith, and I hope our sister Federal banking agencies will be similarly inclined. We are further prepared to ask that Council to study several broader supervisory issues on a priority basis, with a view to developing recommendations to the parent agencies for uniform, up-dated policy positions.

Assuming such a Bank Examination Council is established, experience will soon show how productive it can be in actual practice and how far the scope of its activities might usefully be extended. The Council's success will require a sincere effort on the part of all three agencies to arrive at meaningful changes and to minimize disagreement on less essential items. Its performance will depend most of all on the competence and good will of the individuals designated to serve on it. But that caveat attaches likewise to virtually every other design of the structure of the Federal banking agencies.

The Board appreciates the continuing interest of this Committee in the entire subject of banking regulation and supervision, and we look forward to your deliberations and recommendations. We will be glad to continue to report to you on our activities and will make recommendations for further legislation as we see such needs develop.

BANK FAILURES

REGULATORY REFORM

FINANCIAL PRIVACY

THURSDAY, JULY 17, 1975

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
SUPERVISION, REGULATION AND INSURANCE,
OF THE COMMITTEE ON BANKING, CURRENCY AND HOUSING,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:05 a.m., in room 2128, Rayburn House Office Building, Hon. Fernand J. St Germain [chairman of the subcommittee], presiding.

Present: Representatives St Germain and Brown.

Mr. ST GERMAIN. The subcommittee will come to order.

This morning we again are happy to welcome James E. Smith, the Comptroller of the Currency, who last appeared before the subcommittee on December 11, in connection with our hearings on the failure of the U.S. National Bank at San Diego.

At this point, if there is no objection, I wish to place into the record a copy of the subcommittee's invitation of June 30, addressed to Comptroller Smith.

[The letter referred to follows:]

U.S. HOUSE OF REPRESENTATIVES,
Washington, D.C., June 30, 1975.

Hon. JAMES E. SMITH,
Comptroller of the Currency,
Washington, D.C.

DEAR MR. SMITH: As per our previous discussion and the continuing discussions between our respective staff members, I request your appearance before the subcommittee on July 17, 1975, at 10:00 a.m., in Room 2128, Rayburn House Office Building. At this time the subcommittee will receive your proposals for bank regulatory reform. In addition, we would appreciate hearing your views on bank structural reform since they will be of assistance in our continuing deliberations in connection with the FINE Study. We anticipate the need for a full day to allow for adequate consideration of your views on these important areas.

As you know, on June 18, 1975, I introduced H.R. 8024, a copy of which is attached. On June 26, the Subcommittee on Financial Institutions commenced hearings on this bill, and I am enclosing a copy of my opening statement delivered on that day. In view of your prominent position on the need for experimentation to assist the Commission in its deliberations, your views on Title II

of H.R. 8024 will be essential to us. Your remarks before the Pennsylvania Bankers Association on May 19, 1975, as you will recall, emphasized the role of the Commission in the entire experimental area. Inasmuch as we can anticipate the nomination of a Commission chairman, I trust you will agree that the Commission should have the opportunity to structure the continuing experimentation in a manner best suited to assist it in the discharge of its responsibilities. Your views on Title III, likewise, will be of assistance in our developing of an informational network. It is our understanding that the Coordinating Committee met several times in 1973, at the request of the Federal Home Loan Bank Board, but, unfortunately, was not able to reach an agreement or failed to see a need for a network such as Title III of H.R. 8024 would establish. Deputy Secretary Gardner, on behalf of the Treasury Department, will be testifying on Title I of this bill, but your views of course will be appreciated as well.

We note your recent public statements concerning the status of the Haskins and Sells study which you commissioned. You will recall that in your letter of January 16, 1975, which was in response to my letter of December 27, 1974, you indicated that certain of the consultants' suggested changes were being implemented. We would appreciate being furnished with a copy of that study along with a detailed discussion of those recommendations that have already been carried out, as well as your views on those suggestions which have not been implemented. For the benefit of new members of the subcommittee we would appreciate your presenting a summary of those reforms adopted subsequent to USNB failure and your previously proposed statutory amendments.

The case of the Franklin National Bank along with those of the United States National Bank of San Diego and the Security National Bank have raised serious problems with respect to the adequacy of the present system of bank regulation and the coordination of roles of the different regulatory agencies with overlapping jurisdiction. As we indicated in December, we expect a full and complete report on the process which resulted in the Franklin National Bank being placed in receivership.

In addition the subcommittee would appreciate a full explanation of the procedure utilized in the sale of Security National to the Chemical Bank. Inasmuch as correspondence has been received from aggrieved stockholders of Security National, we would like to be advised of the status of said sale and any pending legal actions in which the Office of the Comptroller has been named a party plus a summary of the legal issues involved.

Finally, we are also interested in the Office of the Comptroller's position on H.R. 2752, introduced by Mr. Stark, and subsequently reintroduced with thirty-six cosponsors and H.R. 1005, introduced by Mr. Rousselot, our ranking minority member, copies of which are attached. We requested your views on the predecessor bills in August 1973, and, as yet, have not received a final response to this inquiry. Also, Chairman Reuss requested a report from your office on H.R. 550, introduced by Mr. Koch, a copy of which is enclosed, on February 10, 1975, and I have been informed by the full committee that their records indicate that no such report has been received from the Office of the Comptroller of the Currency. In view of the subcommittee's interest in the issue of bank secrecy, we would also appreciate your office's position on H.R. 550 at this time. This subject is extremely important since it involves the constitutionally-guaranteed right to privacy. It is important to receive the bank regulatory agencies' views on this legislation because of their familiarity with the internal procedures used in this area and the effect such legislation will have on the roles of the regulatory agencies themselves. In light of the recent court decisions handed down by both the Supreme Court of the State of California (Burrows v. Superior Court) and the U.S. Supreme Court (U.S. et al., v. Bisceglia and CBA v. Shultz), the subcommittee recognizes the need for action in this area. It is our hope to proceed with the mark-up on a bill dealing with this matter upon the return of Congress from the August recess.

In accordance with the Rules of the Committee, to permit distribution to subcommittee members, please submit 80 copies of your prepared testimony to the subcommittee office, Room B303, Rayburn House Office Building, by noon Tuesday, July 15.

Sincerely,

FERNAND J. ST GERMAIN, *Chairman.*

Mr. ST GERMAIN. Before proceeding with questions concerning the Comptroller's position on H.R. 8024, I wish to clarify several aspects of title II, the 90-day EFTS moratorium. As you are probably aware from newspaper accounts, my clarification of the subcommittee's intent by title II led to a favorable response from the Federal Home Loan Bank Board, which has now modified its written position and agreed to a limited moratorium.

First, the use of the word "control" in the bill was not intended to indicate that the Commission would take over from the agencies the authority to approve EFTS experiments or to second-guess such approvals. At the end of the 90 days, the Commission will merely advise the committee of its plans for the evaluation of such experiments, insuring full and adequate consideration of the public policy questions inherent throughout. For this reason, when the subcommittee received testimony from the Federal Home Loan Bank Board earlier this week, I stated that I would be willing to delete the language making reference to "control."

Second, title II in no way affects the continuation or implementation of EFT systems which have already been established. It simply gives the Commission time to get organized, review what has taken place to date insofar as experimentation is concerned, study the procedures utilized by the regulatory agencies, and to advise the respective committees of jurisdiction at the end of a 90-day period of its plans for the continuing review and evaluation of ongoing experiments in furtherance of the Commission's mandated objectives.

From the beginning, my purpose in introducing moratorium legislation, identical to Senator Proxmire's bills in the 93d and 94th Congresses, was to underscore the importance of the National Commission in a continuing effort to persuade the President to activate the Commission by submission of the name of a Chairman and Executive Director for confirmation and appointment of the public members. I am certain you recall my extended correspondence with the President, and remarks to my colleagues on the floor, deploring inaction.

While I believe that the 9-month delay in activating the Commission has been most regrettable, I am troubled by the fact that the statutory members, since the date of enactment of Public Law 93–495, October 28, 1974, apparently have felt they could not confer with each other while awaiting Presidential action to evolve a common position and procedure on the experimentation question.

Each regulatory agency, during the past 2½ years this subcommitee has been studying EFTS questions, on more than one occasion has expressed its support for the Commission. I must state that I am encouraged by your attempts to work our agreement with the intent of title II, as evidenced by your constructive suggestions for restructuring section 203. Likewise, I am hopeful that each regulatory agency will furnish evidence of their support by working together within the Commission framework to insure public understanding and acceptance of EFTS developments.

Mr. Comptroller, you have submitted to the subcommittee a very lengthy and thorough statement. We understand the time-frame within which you are operating. In order to allow the subcommittee to address some questions to you personally—we understand you have

your staff here to answer some of the other questions that we may not be able to get to prior to your departure—as agreed, we will place your entire statement in the record as written, and proceed with questioning.

STATEMENT OF HON. JAMES E. SMITH, COMPTROLLER OF THE CURRENCY

Mr. SMITH. Mr. Chairman, would you like me to proceed on our views on H.R. 8024, those provisions in title II?

Mr. ST GERMAIN. As I said, in order to expedite matters we will proceed to questioning.

On page 6, you state, "Nearly 2 years have elapsed since it was first proposed." That is in reference to the legislation that came about as a result of the Hunt Commission report.

Correct me if my dates are wrong. I believe President Nixon appointed the Commission in April 1970, and they had their initial organizational meeting in June 1970. Is that correct?

Mr. SMITH. I believe that is correct; yes, sir.

Mr. ST GERMAIN. The date of the Hunt Commission report is December 1971?

Mr. SMITH. Yes, sir.

Mr. ST GERMAIN. The agencies and the administration then had the report until August 3, 1973?

Mr. SMITH. That was about 9 months, give or take.

Mr. ST GERMAIN. I am sorry. You are a little off on that. Nine plus 12 is 21.

Mr. SMITH. I am sorry; yes, sir.

Mr. ST GERMAIN. Twenty-one months. At that time there was a draft paper issued, a program for reform, but no legislation. Subsequently, legislation was submitted, initially without the tax components.

Mr. SMITH. That, I might say, is rather typical of the practice in the tax field, because the Ways and Means Committee rarely receives specific legislative drafts, but rather receives narrative descriptions of a recommendation. And the Ways and Means Committee and the Joint Committee staff normally, in cooperation with the Treasury, actually draft the legislative provisions during the course of hearings.

Mr. ST GERMAIN. So it was 20 months from the draft report and a few months more before Congress received the proposed legislation. Then legislation was reintroduced this year by the administration in this Congress, with changes, because the administration evidently became aware of the existence of the credit unions. At that time the legislation was restructured to recognize credit unions.

It took the administration a little better than 3 years to come up with this final draft. To say that the Congress is dragging its heels is unfair when you have 435 members of the House, 100 members of the Senate, as against the slightly smaller group involved in the administration.

Mr. SMITH. I did not mean—I hope what I said did not give you the impression that I was suggesting that the Congress was dragging its feet. I just think that we have reached a point where there has been an opportunity for considerable consideration in the Congress,

indeed, in the other body there have been rather extensive hearings held both in this Congress and in the last one. I do not think that you have any absolute parallel of time consideration between development of a legislative draft and its consideration.

In fairness to the administration, we have done a fair amount of plowing of the field before the matter was received by the Congress. I am just suggesting—I really do not care how the credit is shared, or whether it is shared at all. I am merely saying that I believe the events of 1973 and 1974 indicated that this restructuring effort is one of the highest priority, in terms of the ability of all the deposit financial institutions to effectively serve the public, and more especially in terms of the thrift institutions that definitely need to have their powers broadened in order for them to survive the various cycles in the economy.

Mr. ST GERMAIN. The subcommittee, and the full committee are in agreement with you. That is why we embarked upon our own FINE study. We wanted congressional input and consumer input, which was absent in the Hunt Commission report.

The hearings that we have been holding, on variable rate mortgages and H.R. 8024—have taken into account the restructuring and reform of our financial institutions. They are part of the initial stages of this particular study.

Mr. SMITH. My point here, Mr. Chairman, is one man's opinion. I regard it as a matter of very high priority.

Mr. ST GERMAIN. I assure you that the chairman of the Committee on Banking and Currency and all the members feel the same way.

On page 9, you refer to the temporary 90-day moratorium, and the fact that, if it should fail to meet its goals, there might be a need for an extension of that moratorium. As a drafter or a codrafter of the legislation that created the moratorium, I point out that the majority of the members are all individuals who are appointed by statute, and are very familiar with electronic funds transfer systems. I am referring to the Federal Reserve Board, the Attorney General, the Comptroller, yourself, the Home Loan Bank Board, NCUA, the Postmaster General, the Secretary of the Treasury and the Chairmen of the FTC, FDIC, and FCC. There are also seven members from the trader organizations, who certainly have been picked and recommended because of their familiarity with the subject.

It is not as though you are bringing a group of people together who do not know about EFTS.

Mr. SMITH. I would hope that is the case.

Mr. ST GERMAIN. Then, I look further on——

Mr. SMITH. May I just respond there, Mr. Chairman.

Mr. ST GERMAIN. I will give you a little something else to respond to.

I note that on page 21 of your statement you say that "within the first 90 days" of the Haskins & Sells study you received reports.

Mr. SMITH. One of the principal participants in the study for Haskins & Sells is Gene Larkin, a partner in charge of their banking group.

Mr. ST GERMAIN. The point is that within the first 90 days of the first comprehensive study or review of the Comptroller's Office in its 112-year history, you requested them to furnish you their initial impression of the operations of the Office. You go on to state that as a

result, you were able to identify several areas where improvements could be commenced without waiting for the completion of the study.

Mr. SMITH. I would also point out that the Office of the Comptroller continued to operate in that 90-day period. We did not suspend operations.

Mr. ST GERMAIN. Just as you contracted out to a consultant for recommendations for reforms, we in the Congress have mandated a Commission. As I have stated, title II simply allows the Commission time to get organized, review the experimentation conducted to date, study the procedures used by the regulatory agencies, and advise us of its plans for the continuing review of the experimentation. We do not view this as a staggering task in its first 90 days of life.

Therefore, as you requested Haskins & Sells to furnish you their initial impressions, we likewise are asking the Commission to furnish us its initial impressions, at the end of the 90-day period, in order to determine whether there should be any action on the part of the Congress before the conclusion of this study. We do not intend to suspend operations of any of the systems that are ongoing.

Mr. SMITH. Of those that are ongoing?

Mr. ST GERMAIN. We merely ask that approval of any further systems be suspended for the initial 90-day period.

I assure you that this member and, the other members of the subcommittee who support this legislation—have no intent to hold up progress and do not intend, although we have been requested to, to extend the moratorium beyond the 90-day period. Therefore, based on those facts I would ask you to formulate your opinion.

Mr. SMITH. No. 1, the opinions that were expressed in the bill reflected some contemplation.

Mr. ST GERMAIN. I realize that.

Mr. SMITH. I do not think that we are going to produce much of constructive assistance to the committee by trying to draw a parallel between title II of H.R. 8024 and the procedures that we employed with the contractor on the Haskins & Sells study.

No. 1, the Commission is not comprised in its members of people who are going to be devoting full time to the work of the Commission. As you well know, as a veteran of this town, and with the creation of any commission, the first and most important task is to get a staff and to get the Commission off and running and find places to house the staff and all of the logistical support that is essential there.

I do not quibble one bit with the idea of the Commission coming back to the Congress and coming back to the regulatory agencies themselves with impressions and recommendations, that they might have, one, for an interim system of regulation during the life of the Commission, or, two, for some system of monitoring which would permit both the Commission and the Congress to more effectively follow the course of events.

What I am objecting to is, one, tying the Commission down to a precise 90-day period and, more important, asking that ongoing activities in the field be suspended.

Now, you say that you are not asking that, that you are saying people who are in place, people who have filed notifications under our procedure, people who have filed applications under the Home

Loan Bank Board procedures, would be permitted to go forward. We are dealing with the private world of commerce in which people do not make decisions that way.

You can create in that 90-day period, or, if necessary, if you had to extend it to 180 days or 270 days, however long it took the Commission to get back to you—you could begin to create some competitive problems in particular market areas where an institution has moved and has a system up and running and another institution was caught in midair in the planning process.

Our fundamental problem, Mr. Chairman, is that there has been no evidence to date of any injury to any party, to any institution by what has taken place. We just do not see what useful purpose a moratorium is going to serve.

In the period since we issued our initial interpretation in mid-December 1974—I checked my arithmetic here, but I think that is about 8 or 9 months now, is it not? We have had 30 institutions notify us of the intention to establish EFT facilities out of a universe of 4,700 national banks. It hardly seems to me that is evidence that anybody has suffered any undue injury. I think that you could expect that same developmental course to take place during such time as you wanted the Commission to get back to you.

I just do not see the legitimacy or the value of suspending operations for 90 days, or whatever period it may take for the Commission to get back. I can see that some harm could result from that.

Mr. ST GERMAIN. You said 9 months, 30 systems?

Mr. SMITH. As of July 10 we had received 30 notifications.

Mr. ST GERMAIN. In 9 months. That is an average of 10 per month in a 3-month or 90-day period. Your statement can be interpreted either way.

What harm if 10 national banks——

Mr. SMITH. Wait. You are talking about moratoriums, Mr. Chairman. It seems to me that the burden of proof is heavily upon those who are recommending a moratorium, to demonstrate that it has some valid public purpose and some valid public need. There is no evidence to suggest that to date.

Mr. ST GERMAIN. On page 9, you state, "Since there is no real need for a moratorium and since the results of such retarding action would effect a disservice to the public." As I have asked of other witnesses, I wonder if you can cite us any demand by the public for EFTS services?

Mr. SMITH. I think it varies from market to market. Yes, we received testimony during the course of 2 days of administrative hearings that we held back in April that would suggest that, as the public becomes educated to the use of this type of service, that the volumes build up, which would indicate, yes, there is a demand.

You know, there is rarely an "identifiable demand" within the public for any particular technological development until some developmental effort has taken place in practice and the public actually has a chance to see what it is that is being offered. It is kind of a hackneyed analogy, but I was not aware that there was any gigantic public demand for color television 10 years ago. The fact is that it seems to have been rather well received by the public.

No; I would not expect the public to be storming the bastions down here demanding it, until they understand what the service is.

Mr. ST GERMAIN. On page 1, line 3, would you list the lessons learned from the recent bank failures you refer to on page 1 of your statement, so we may decide whether better coordination, which you apparently favor, is to be preferred over consolidation, which you oppose?

Mr. SMITH. Have we moved now?

Mr. ST GERMAIN. Page 1, line 3; page 1 of your statement.

Mr. SMITH. Yes. I think my views on consolidation are fairly well known by now. Yes; I think that there is always room for more coordination among the three Federal banking agencies.

For example, with reference to the topic that we were just discussing, I think that there is going to be a great deal of need for coordination over the next several years. We hosted a session just in the past week for our fellow regulators, not just the banking regulators, but the FCC and the Justice Department, as well, to receive a presentation from the Mitre Corp., a quasi-governmental research organization that has done a lot of work in security, with regard to electronics and communications systems.

There are genuine security problems associated with the development of an EFT system that we must begin to address. They are not imminent; the stakes seem not to be high enough at this point to make criminal access to those systems a real, present threat. But a future threat there is genuine.

We need to begin to address those, and we need to begin to address them in a coordinated way, not just among the agencies but in the industry, the manufacturers, the vendors, as well.

With reference to coordination, I have had some discussions with Governor Holland, who was your witness yesterday, about this idea of the creation of a so-called bank examination council. I am generally pleased with that idea. We do a lot of that sort of thing in an ad hoc way today. But I think that to formalize such an entity and to the degree that the three agencies can legally and practically vest into the participants in that council, some decisionmaking authority which would be binding on the three agencies, I think that probably would be a useful step forward, giving special attention to coordinating examination and supervisory activity, as apart from regulation and statutory interpretation, in which there are a lot of policy questions that I think must always be retained in the principles of the agencies involved.

Mr. ST GERMAIN. On page 2, line 6, when you use the words "cosmetic approach," are you referring to Dr. Burns' comments in Hawaii last year?

Mr. SMITH. I was not referring to anyone's comment. I think in terms of what have we learned in the last 2 years, that the high priority is for all of us to get actively about the business of modernizing our supervisory techniques—that is where the real progress is to be made.

I have said, and I would say again, the way we do our business in the Comptroller's Office is not strikingly different from the way supervisory work is done in the other two agencies. I think that we all have to play some catchup ball. It probably has been a little bit of an over-

statement, but if you want a very large, early to mid-20th century banking agency, the way to get it is to consolidate now.

I think that the better course is to keep those agencies as they are and to encourage them to modernize and to interact with each other, indeed, to some extent compete with each other. There is some competition. I think it is a wholesome competition that works in the direction of improved performance on the part of each of the members of the tripartite system.

Mr. ST GERMAIN. You do not think it is "competition in laxity"?

Mr. SMITH. No, sir, I do not.

Mr. ST GERMAIN. On page 3, line 8 of your statement, how extensive is the note-sharing that you refer to? Does experimentation, as you term it, create inconsistencies or overlapping requirements?

Mr. SMITH. There is no question that in any process of experimentation you are going to have some overlap; you are going to have some inconsistency. That is almost the nature of experimentation, by definition.

For example, in this particular area, the effort of all of us to come up with some techniques for an early warning system—it is not a new effort. It has been tried in the groves of academe; it has been tried by financial analysts and others. We do not presume that we have any magic answer here.

What, in effect, we are going to be trying to do, Mr. Chairman, is to develop a big screen analysis of banks on the basis of ratio analysis; to use some ratios that, perhaps, have not been used before, to use some that have been, but to use them with data which is more current. In terms of the application of the ratios, I cannot tell you that it is going to be a success.

In its nature, it is not unlike what financial analysts do today, except that we have two distinct advantages over the financial analysts. One, we can verify and validate the data that we use in ratio analysis; the private financial analysts cannot. Second, when we see ratios for a particular institution tick away from what would be deemed the norm for institutions for their size or structure or geographic circumstance, the financial analyst is left to conjecture or speculate as to why those abnormalities are occurring. We have the legal authority to get inside the institution and analyze that for ourselves.

I am hopeful about it, but I do not say it is a sure thing. I know the Fed and the FDIC are working at similar tasks. I think the three of us can benefit from the work of each partner in the group.

Mr. ST GERMAIN. You are aware that the subcommittee, after each bank failure, has been told that, among other things, what is required is greater coordination. Unfortunately, it does not seem to occur.

Would you be able to be a little more specific as to what you mean by greater coordination?

What steps have you taken and will you take to insure this greater coordination?

Mr. SMITH. I am thinking in terms of coordination. I am thinking here primarily in terms of techniques—referring again to an early warning system—that is going to demand a much higher utilization of data collected from banks and collected with much greater frequency than we do today.

Now, for that system to practically succeed, it is going to mean that we will have to coordinate with the other two banking agencies on the types of information that we are going to be requesting, on the form in which that information is going to be requested, so that we do not put an unholy burden on the reporting institutions. They are constantly seeking data and information on a reporting basis from banks, as well, and it is essential that that be coordinated so that the requests are, to the greatest degree possible, uniform.

I think there are many other areas where coordination is needed, where, indeed, we do coordinate, in terms of identifying developing problems. For example, in the standby letter of credit area, which was a problem in the San Diego case, as you know, which action was taken after the fact. Perhaps with greater coordination, with each agency communicating as a group to each other about what we are finding in our banks, what they are finding in their banks, we would have identified earlier on this as a trend that needed to be treated within a regulatory manner.

Mr. ST GERMAIN. Would you include the SEC, Mr. Smith?

In USNB and, I believe, in Franklin, also, there was concern expressed by the SEC prior to concern being evidenced by the regulatory agencies.

You should learn from the past. It seems to me that some serious consideration should be given to this point.

Mr. SMITH. I think there is no question, Mr. Chairman, that there is going to be a considerably higher degree of communication and coordination between the SEC and the bank regulatory community in the future than there has been in the past.

Part of that is derivative of recent statutory enactments that further get us into their business and get them into our business. So that I think the course of the future is definitely one of greater coordination.

Mr. ST GERMAIN. Do you feel this is a healthy situation, and that coordination would be helpful?

Mr. SMITH. Yes; I do. We have a project ongoing right now which is but weeks away from completion on which the four agencies have been working diligently on the question of additional financial disclosure by bank holding companies and by, especially, major banks to find banks with assets of $250 million and up. The results of that are going to be, I think, from the banking agency standpoint, a rather significant increase in the data requested through the quarterly calls and through the income and dividend reports also.

Those reports will be provided with greater frequency than they are today by that category of banks, $250 million and up. That is going to benefit investors; that is going to benefit uninsured depositors. From my selfish standpoint, it is going to benefit me in terms of the modern techniques that we want to apply in supervision.

Mr. ST GERMAIN. Will it not benefit the financial institutions themselves?

Mr. SMITH. I think it will.

Mr. ST GERMAIN. On page 6, line 6, you seem to say that regulation Q gives an unsteady amount of funds. Are you advocating the removal of ceilings on interest be paid to savers?

Mr. SMITH. Over a period of time.

Mr. ST GERMAIN. What time frame do you have in mind, Mr. Smith? The bill includes a period of approximately 5 years, at the end of which time there would be a review. It is the administration bill that is over in the Senate. In our hearings on variables, one of the arguments expressed by many of the proponents, was that the removal of ceilings would enable banks to take care of the depositor who has been taken advantage of and has been subsidizing the home purchaser over the years. When I attempted to, get a time frame from the trade associations and from the Home Loan Bank Board, it just was not forthcoming.

I am wondering what you feel a time frame might be.

Mr. SMITH. Well, I had some part in developing the 5-year proposal That fact being there, especially in the area of additional lending and investing powers, more particularly in the area of consumer lending powers, understandably, it would take a thrift institution a period of time, and that was kind of selected arbitrarily to, one, staff itself for that function, because the credit considerations in retail banking are quite different than they are in mortgage lending, and to get that operation up and running in any institution.

So, I think when you look at that particular feature of it, I think that you could suggest that 5 years is probably a reasonable period. If you are talking about an institution which is already in that area, as some thrift institutions are, especially mutual savings banks in certain States, then you are talking about a grant to them of the third-party payment power. I do not think that it takes that long to become competitive in that third-party payment market. I do not know that 5 years is necessarily an essential lag before the differential is removed in that sort of circumstance.

Mr. ST GERMAIN. Would you care to elaborate on how you feel FIA–75 would insure a steady flow of mortgage financing?

Mr. SMITH. I do not say that there is any system that is going to assure a steady flow. I guess what I am saying is a steadier flow, simply by giving these institutions, one, the competitive opportunity through the removal of rate ceilings to compete with other savings and investment media during cyclical periods of high rates in the short term area.

Mr. ST GERMAIN. It would take 5 years or more before this would begin to come into practice.

Mr. SMITH. As I say, that is sort of an arbitrary judgment. If we were to conclude that my conclusion has some validity, the sooner we get that process, obviously the better off we are. If the lag is 2 years, 3 years, or 5 years, obviously for thrift institutions especially to be able to compete in that short term rate area during periods of higher short term rates, they obviously have to have the ability to invest funds in shorter term, higher yielding assets to some extent to be able to generate the income with which to compete on the savings side. And I think that once equipped with those additional powers, I do think they will be able to compete. I do think they will suffer less severely the impact of disintermediation during periods of sharply rising short term interest rates. Their ability to stay in and continue to maintain and receive deposits obviously materially affects their ability to put the funds out on the other side of the book in terms of mortgage lending.

Mr. ST GERMAIN. When I read your statement on Franklin National, I did not see any reference to an alleged negotiation around May 6, 1974, between representatives of Franklin and a Mr. McGillicuddy, president of Manufacturers Hanover Trust. I understand that he had expressed a very keen interest in acquiring Franklin National.

Mr. SMITH. Let me get to that statement, if I may. Maybe my staff associates here can help me identify it. What, in affect, I indicated, Mr. Chairman, was during that weekend, there were contacts made with major New York banks with respect to the likelihood of a quick merger transaction. Some of those institutions, for reasons that they deemed good and proper, were not interested that weekend. I did not necessarily think I ought to identify the institutions. But Manufacturers Hanover was one of the institutions.

I talked to Mr. Houge, I believe. I talked with John McGillicuddy as well. I did not directly contact Morgan Guaranty, but my office in New York was in contact with them, and I believe that the New York Fed was in contact with Morgan. And we had some conversations via New York Fed with the Irving Trust. Obviously Manufacturers, because Manufacturers had a rather substantial loan to the Franklin National Corp., the parent holding company, it could have been assumed that Manufacturers knew more about Franklin than any of the other banks, for that reason.

As it turned out, on that short term basis, and on a purely commercial basis, they concluded that they were not interested.

Mr. ST GERMAIN. Was it a question of terms not being met?

Mr. SMITH. That was not a question. Nor was it a question of an FDIC-assisted transaction. What I told Mr. Houge in particular, as I recall; if they could reach a commercial agreement with the directors and management of the Franklin National Corp., that I would seriously consider—and I say consider, because this is not something that one just does idly—moving under my authority under section 181 to waive shareholder approval, and I might even consider moving under my conservatorship powers to stand in for the shareholders and management of the bank, and conclude a transaction.

Even with that assurance on my part, they seemed not interested at that time.

Mr. ST GERMAIN. On page 43, you refer to former Secretary of Treasury Kennedy, to Mr. Schreiber and Mr. Anderson, officers and directors of the bank and bank holding company, and members of its executive committee. Was Mr. Schreiber brought into the bank as part of an effort by your office to initiate an attempt to improve management?

Mr. SMITH. No; he was not. The origins of him coming to the bank were either Mr. Gleason or Mr. Sindona had become aware of the fact that Mr. Schreiber, who just months before that had retired after a very distinguished career as a chief executive officer of Walter Heller & Co., a major national finance concern, was finding retirement not to his liking, and was looking for something to do. He is a first-class—he had come to Walter Heller in the first place as a management consultant, so he was a problem solver by reputation. And based upon my exposure to him, had he gotten there earlier, he might have been able to turn that one around. He identified the problems rather quickly.

Mr. ST GERMAIN. Mr. Anderson served as a director beginning in 1973. It would appear from the statements in the prospectus filed with SEC in March 1974 that he was a Sindona appointee, one of the nine who made up the Sindona majority on the board.

Mr. SMITH. I cannot confirm who it was who approached Ray Anderson to come with Franklin. But he again is a fellow who had a very fine reputation. I am personally acquainted with the man who was his immediate senior at Bankers Trust, and a guy I have a lot of respect for told me that Ray Anderson is as good a credit man as he has ever dealt with. Certainly, my own exposure to him would indicate that he is a first-rate loan and credit man. But the facts are, you cannot turn a loan portfolio around in 6 months in that kind of environment.

Mr. ST GERMAIN. You mentioned the fact that Mr. Schreiber had been with Walter Heller International. That is an Illinois-based finance company?

Mr. SMITH. Yes, sir. So the question is: Did he know Mr. Kennedy? The answer is yes, and well.

Mr. ST GERMAIN. Not only Mr. Kennedy. In February 1974, Walter Heller held the major portion of the assets of Sindona's nonbanking interests in the United States, Argus, and Interphoto, as collateral for loans to those companies Heller had been Sindona's principal U.S. creditor for several years; as well as that of Continental Illinois, with which Mr. Kennedy was associated and which held a 26-percent participation in the Heller loan, according to the prospectus filed with SEC in December 1973. So, these were all Sindona-related people, were they not?

Mr. SMITH. That would not be a fair characterization of Mr. Schreiber. I know nothing of what business dealings there may have been between the Heller Co. and Sindona interests. But to, in any way, characterize Norman Schreiber as some sort of Sindona functionary would be about as far from the truth as would be possible.

Mr. ST GERMAIN. I did not say functionary. I said there was a relationship.

Mr. SMITH. There may have been a relationship between the company that Mr. Schreiber once headed and Sindona interests. There was a relationship between the company that Mr. Schreiber once headed and the bank that Mr. Kennedy once headed. Those were normal commercial relationships.

Mr. ST GERMAIN. Of course, Mr. Kennedy had a relationship with the Sindona interests.

Mr. SMITH. He was indeed a director of Fasco, which was a Sindona holding company, and was along with Mr. Sindona entrusted under a legal agreement to have whole voting rights on Franklin National stock which was held by Fasco. And that weekend, when I discussed with Mr. Sindona what I thought was a continuing problem—the fact that the market seemed not to have much confidence in him, for reasons that I did not presume to understand. I said, there is no question, Mr. Sindona, in terms of the ability of this bank to raise the short term funds. Your voting position in the Franklin National Corp.. I think, is a negative factor; and I said I would like to recommend to you that you consider placing the Franklin National stock that you have the voting power over in another individual whose integrity could in no way be questioned.

I will say, for the record, it is not in here that I suggested Norman Schreiber. I knew nothing of the Kennedy agreement at that point. By that time, Mr. Schreiber and Mr. Sindona were having some differences of view about the institution. He rejected that suggestion. He said, I will tell you what I will do. He said, there is an agreement in place that gives to me and David Kennedy sole power to vote the Fasco-held stock. He said, I will agree for a period of 1 year to render my power to vote, which means that David Kennedy would be the sole voting power. I said I could hardly object to that arrangement, having worked with and known David Kennedy well; having great faith both in his integrity and financial knowledge. I said that is an acceptable arrangement to me.

Mr. ST GERMAIN. In your review of Franklin, do you feel that somehow, the mismanagement policies that were responsible for the problems at Franklin were initiated principally by Mr. Sindona? I specifically refer to the substantial increase in the bank's international business.

Mr. SMITH. I think that he was definitely a factor in encouraging the bank in that direction. I think that, as events developed, it indicates that they did not have the management resources to enter the international theater to the degree that they did. I think also, in real candor, that you would have to say that there was some dereliction of duty on any director who was a 20-percent shareholder in an institution in permitting the inadequate management that was occurring in that bank to continue. Obviously, there were steps taken in late 1973 and early 1974, with Anderson and Schreiber, to try to beef up that situation. They came altogether too late. I think he must bear some of that responsibility.

Mr. ST GERMAIN. The subcommittee will stand in recess for about 10 minutes, so that we can go and vote.

[After recess.]

Mr. ST GERMAIN. The subcommittee will come to order.

Mr. Smith, on page 23 you refer to the need for improved credit information.

Yesterday, I asked Governor Holland a series of questions about large international syndicated loans. He indicated there was a need for improved information, as far as participating banks are concerned. He thought that banks which take participation in these loans, both foreign and domestic, particularly the large international loans, must take responsibility for obtaining adequate information.

Would you comment on that?

Mr. SMITH. Yes. Let me say, Mr. Chairman, if you decided to ask one of my deputies this afternoon, Deputy Comptroller Robert Mullin, who was responsible for establishing the national division in our office, and probably can talk a great deal more expertly in this area.

We feel, generally, that banks that are participating in syndicated credit should not rely wholly or in substantial part on the agent bank or the lead bank to develop financials on the credit, that each bank that has a participation owes it to itself and shareholders to inform itself as well.

On these larger credits, we are endeavoring to do a better and more uniform job of our own evaluation of them. We recently, in the past

6 months, instituted a program of uniform classification of credits of $20 million and up, of which there are several banks participating. We used a team of examiners from several of the major money market regions, going into the lead bank on the credit to do the credit evaluation. It produces a uniform classification. It also permits us to use some of our best commercial credit evaluators on these big, tough credits. And we think it produces a better result, from our standpoint.

To answer your question, I think, yes, in the area of participation, that some banks have been lax in relying too much on the lead bank or the agent bank to provide the financial workup.

Mr. ST GERMAIN. When you consider the fact that there is a legal limit on loans to one borrower in relation to capital, as a result thereof only the largest banking firms can manage these syndications. There are very substantial fees paid to the lead bank. Franklin was paid $300,000 for a commitment to place a $200 million loan overseas. In fact, Franklin had only $226 million in capital, and it would take a bank such as Bank of America or Citibank with capital of $2 billion to undertake such a commitment without violating the legal lending limit, as Franklin did. I believe these are the only two U.S. banks with capital funds in that amount.

Would you give us your views on the risk to banks involved in loan syndications, and how these have built into the banking system substantial profit advantages for large banks, and the resulting increase in bank concentrations?

Mr. SMITH. I think if we take the question of syndication itself, I think that if we want to retain a banking system that has a substantial number of units and participants in the system, that syndication is essential to that objective or to the coobjective of one maintaining a number of units in the system and also serving sizable demands for credit.

Now, as to whether, in a syndicated loan, the agent bank skims off the cream, so to speak, if you will, on the transaction, I think that that becomes a function for the participants in the system. You find, in talking with regional banks and smaller banks that have been participants in major syndicated credits, that they are not on all occasions happy with the arrangements, in terms of the placement of compensating balances and so forth.

And there is some genuine grousing going on that, I imagine, over the course of time will result in some of the syndication agreements taking a different form. I think that is the forum for that question of who gets what portion of the return on a loan to be resolved. I do not necessarily think that that is the business of Government or the regulator.

Of course, syndication is, in part, too, an outgrowth of the legal lending limits that are a matter of statute and law. I cannot tell you that I know for a fact that the present provisions of 12 U.S.C. 84 are the exact provisions that we ought to have, whether it ought to be 10 percent of the capital structure of the bank, or whether it should be 5 percent, or whether it should be 15 percent. But that is the law today. It certainly is a factor in encouraging syndication.

Mr. ST GERMAIN. Do you feel that there are adequate examination of the branches of our domestic banks that are functioning in foreign countries?

Mr. SMITH. Again, I think that this is a topic that you might want to speak with Mr. Mullin on. I suppose if we could request an ideal situation, Mr. Chairman, we would like the unconditional, nonequivocable right to make onsite examinations of every single branch facility in an international system, just as we do the domestic system.

The fact is, in a multinational climate, you are dealing with national sovereignty. We get quite good access. Of course, we are more and more encouraged, and to the extent you can, insisting that these major multinational banks maintain quite detailed and quite adequate current records of their international operations in the head office or in the regional offices abroad, to which we do have considerable access.

That is a developing activity. It is not to the level, perhaps, that we would like in each and every institution, but it is getting better. And it is improving our ability to track their international operations.

Mr. ST GERMAIN. There are many resasons for asking that particular question. The case in point is that notes on the Franklin examination reports reveal that, as late as August 1974, examiners were unaware of what was going on in Franklin's London branch. The examiner detailed the foreign exchange position of the New York and Nassau offices, and noted that it was impossible to evaluate the London branch's position.

He said, however, that the London foreign exchange trader could no longer trade there because other banks would not deal with Franklin, and that coverage of his gaps had to be provided by the New York office. As a result, the gap exposures in the London branch surfaced, and the examiner anticipated that the effect would be to aggravate the already monumental gap exposures in New York.

Here we are in August. Franklin had been in the hands of regulators since May. The actual volume of its contingent liabilities of foreign exchange contracts in London was not known to the authorities. Nor did they know the size of the branch's exposure and its potential for losses. If information on overseas branch activities is that scant, how can we justify permitting substantial portions of the business of some of our very, very large banks to be handled through their foreign branches?

I would assume that you are attempting to improve this situation as far as the supervision of foreign branches is concerned?

Mr. SMITH. There is no question that there have been very significant changes with respect to foreign exchange activity, as a result of the unhappy events in Franklin, the Herrstaat, and others, as you know. The principal problem that resulted in the over $40 million of foreign exchange lost in the Franklin were unrecorded and unauthorized transactions by one or more traders.

Now, there are certainly internal control systems that can be developed that cut short that sort of performance. I think we felt, at one point in the Franklin, that they had developed adequate systems in that regard. The fact is that their internal audit operation for foreign exchange and for their international operations had become entwined with the operating section, so that it was, in fact, not an independent unit at all. So, therefore, those transactions were permitted to go undetected for a considerable period of time.

I am satisfied from discussions with my own examiners that, had we been onsite, had we been in that bank at the time that those transactions were occurring, we probably would have detected them. We now have in place a system which will be partially helpful in this regard, and that is, as you know, right after all of the foreign exchange activity, the Treasury Department put in effect a weekly and monthly reporting system by U.S. banks on their foreign exchange positions in the nine major currencies.

We think that the most useful of those reports is the monthly report. We are now computerizing that monthly report so that we have quite current information on the foreign exchange activity of our major national banks. And as we see things developing there that look to us to be out of the ordinary, we would move immediately to get in and find out what is going on. If we had had that in the case of the Franklin, we might have interdicted that activity before it got out of hand.

Mr. ST GERMAIN. Mr. Smith, we now have a vote on an amendment. It is my understanding that we have quite a few votes on amendments today in addition to the fact that quite a few of our members are in the Post Office and Civil Service subcommittee meetings. They are deliberating the important legislation on postal rates. That is the reason for the fact that the members have not been here this morning, not because they are not interested in your testimony.

In view of that, and in view of the fact that you have a previous commitment which will be taking you away from us, we will adjourn. The staff and I and other members of the subcommittee have a number of questions that we would like to have answered for the record. We will, therefore, submit them to you in writing and ask that you be as responsive as possible, because many of the questions are geared to the reform of financial institutions. We are not just dealing with Franklin and USNB from casual history, but rather to learn from what occurred so that we may use the results of these hearings along with the great deal of other work that we are doing in the FINE study. So it would be most helpful to the subcommittee to receive your answers to these written questions.

On the question of privacy legislation, we would like to have you assign somebody on your staff to work with our staff on that legislation.

Mr. SMITH. Fine.

Mr. ST GERMAIN. With regard to title II, the moratorium legislation on the EFTS. If you would also assign someone to work with our staff, I think we can resolve a good many of the differences.

I appreciate your basic objection, but at the same time I think that it is to your advantage to have our staffs work together. I feel that you probably would like to have as much input as possible?

Mr. SMITH. Yes, sir.

Mr. ST GERMAIN. Your testimony this morning has been helpful to us.

With that understanding, we will adjourn the hearing until 10 o'clock Monday morning. We thank you for your appearance and contribution.

Mr. SMITH. I thank you for your consideration of my week's vacation.

[The prepared statement and attachments of Mr. Smith follow:]

Statement of the Honorable James E. Smith
Comptroller of the Currency
before the
Subcommittee on Financial Institutions
Supervision, Regulation, and Insurance
of the
House Committee on Banking, Currency, and Housing
Thursday, July 17, 1975

Mr. Chairman and Members of the Committee:

I appreciate the opportunity to appear before you today in connection with bank regulatory matters of current interest to your Committee. You have requested my views on an extensive number of topics. I shall be happy to comment on these specific areas. Likewise, let me assure you of the desire of our Office to participate in the continuing deliberations of your Committee on the FINE Study.

Bank Regulatory Reform

As may be noted from my public statements, I am not persuaded that unification of bank regulatory functions would produce better supervision. While lessons were learned in the recent bank failures, nothing in these experiences suggests consolidation would have aided us. The appropriate matter to consider is not restructuring, but rather the supervisory tools themselves. It, perhaps, would be easier to discuss administrative framework and ignore the more difficult, but crucial, questions of examining techniques and methodology. Unless these issues are solved, the

structure in which the methods operate will be irrelevant. I would argue that our entire attention, therefore, should be directed toward insuring that the regulatory and supervisory tools be made adequate for the increasingly complex banking scene. It ill-serves the soundness of the banking system for us to be diverted toward what is, in many ways, a cosmetic approach.

The study which I commissioned the firm of Haskins & Sells to make was intended to keep the Office abreast of fitting procedures and techniques. As I indicate later in my testimony, we will soon be altering and adding to our present examining scheme. For example, we will give consideration to analysis of financial data and less attention to detailed verification. Examination techniques will be applied with more selectivity. Procedures will take more cognizance of the modifications needed between examining quite sizable institutions and small, less complex banks. Additionally, we are developing a surveillance system which will act as both a tracking system and a manpower utilization instrument through the rational allocation of examining time on a need basis. By the use of trends in key indicator financial data within peer group banks, problem areas will be observable on a more continuing basis than provided by our present examination process. Although not immediately functional as a "flashing light" version for early warning, with time we will have the opportunity to determine useful data and ratios.

It is this process of research and change which offers the most promise for effective regulation, rather than tinkering with the umbrella under which to put it.

Indeed, the revisions we are undertaking point to one real strength of the trichotomy: experimentation. Under the tripartite system, separate laboratories are allowed to test various new approaches. Each agency has the freedom to attempt different formulae. While notes are shared, duplication is not necessarily the result. For example, this Office's not being alone in exploring early warning systems and cross-pollination among the agencies will allow the best aspects of each system to be shared with the other agencies. Just as in private enterprise, size alone is not necessarily conducive to innovation. Competition among smaller units often produces added competence in government as well as in business.

It should also be noted that consolidation would be centralizing some rather significant functions in one almost omnipotent agency. Bank regulation is simply too important to leave to a single regulator from whom, for all practical purposes, there is no appeal. The now famous phrase of "competition in laxity" may be no more than a description of the healthy flexibility which presently exists. It would be ironic, given the recent discussion of the non-banking agencies' ability to stultify their industries, for us to now move to similar control of banking.

Despite my skepticism of consolidation, I do support greater co-ordination. As such areas as early warning systems are being developed, it is incumbent on us to avoid duplication where possible. Since our detection procedures will need to be fed more data than is presently collected, co-ordination must be close or the banking system will justifiably view us as never quite satisfied with the last bit of a ratio. Additionally, there are other areas of mutual concern and interest such as EFTS technical standards, security arrangements, and interchange capability.

Finally, I wish to stress once again my belief in the inherent strength of the trichotomy. Under the present scheme, each agency has a unique forte which I fear would be homogenized beyond recognition if unification occurred. The F.D.I.C. possesses a particular insight into the typical bank in this country, and is a strong voice in federal bank regulatory issues on behalf of state banking systems. Were its functions combined in a single framework, this viewpoint might well be blurred. The Comptroller's Office, due to its unusual, historic development, has the advantage of a single chief executive - a fact which, on occasion, allows for expeditious decision-making in regard to regulatory issues. Consolidation would undoubtedly occur within a "board" context and, despite that organizational form's advantages, banking regulation would lose the catalyst of one of three agencies' being able to respond with greater rapidity than normally allowed a more formalized board. Finally, the Federal

Reserve Board, as a result of its monetary function, has a magnificent data gathering and research capacity. An independent, single agency would not have the benefit of this capacity other than by grace. Additionally, it is probably useful to the Board of Governors to possess bank regulatory duties in conjunction with its monetary function. By combining the trichotomy, the structure would lose many of the distinctive qualities. I trust we will not be cavalier in abandoning a richly diverse system for a sleeker, but less dependable, model.

The final point which needs to be made is that, regardless of the state of perfection in supervisory oversight, the only way that perfection will be material is for the agencies to possess the willingness to treat emphatically with bank problems, be they in small or nationally significant institutions. Consolidation simply does not insure that the requisite will to respond adequately will exist. Without this ingredient, no amount of supervisory expertise will help.

Bank Structural Reform

In contrast to my basic confidence in the regulatory structure, the events of 1973-74 again demonstrated that the present structure of financial intermediaries is particularly vulnerable to disintermediation. As the short-term interest rates rise, both banks and thrifts are placed at a disadvantage in competing

with other savings and investment media. When Regulation Q ceilings are surpassed, the money drain increases as rates climb.

Given the stated purpose of the present rate differential between S&L's and commercial banks, it is ironic that the "cure" causes a less stable and steady flow of funds to support home mortgage financing. But aside from its questionable efficacy, the Regulation can also be faulted as being unfair to the consumer. The large depositor is not harmed, but the average citizen is forced to earn less in a financial institution than his wealthier compatriot.

It seems to me that given the increasing similarities of financial competitors as a result of piecemeal changes and the justice of allowing small depositors equal treatment argue strongly for early passage of the Financial Institutions Act of 1975. It is understandable that Congress would want to retain the right to reach conclusions in the area, but I think the long-term best interest of thrifts and consumers is best served by Congress delaying no longer the serious consideration of the package. Nearly two years have elapsed since it was first proposed. Action seems to be called for.

Electronic Funds Transfers

In Title II of the proposed bill, several rather diverse and complex aspects of emerging EFTS technology are addressed. I support some provisions of Title II; other provisions I oppose.

Section 201 would serve to redefine the lifespan of the National Commission on Electronic Fund Transfers and clearly reflects Congressional intent that the Commission have available the full two-year term in which to accomplish its critically important tasks. This redefinition should serve to allay the concerns that, absent the full term, the Commission could not adequately address the complete range of tasks originally envisioned by its creators. The Comptroller's Office therefore supports Section 201.

Section 202 causes serious problems in that it seems in subparagraph (a) to confer on the National Commission an element of regulatory oversight and control. I question whether such powers were originally envisioned for the Commission. Public Law 92-495 sets forth the purpose of the Act "to establish a national commission to conduct a thorough study and investigation and recommend appropriate administrative action and legislation, both State and Federal, necessary in connection with the possible development, implementation, and regulation of public and private electronic fund transfer systems." The investigatory and recommendation functions are neither consistent with nor compatible with those of control or regulatory oversight. A more workable proposition might be for the Commission to recommend to Congress a reporting system through which the Federal Regulatory Agencies might keep both the Commission and Congress apprised of current developments within the institutions under their regulatory jurisdictions.

In Section 202, subsection (b), a 90-day moratorium is proposed. I oppose a moratorium of any kind or duration for a number of reasons. First, there appears no present need for such drastic action. Substantial evidence was provided Senator McIntyre's Senate Subcommittee on Financial Institutions during recent months to the effect that any stoppage or severe retardation of the development of this new technology would serve to deny the public the convenience and efficiency benefits of emerging EFTS service offerings and might be sharply anticompetitive as well.

Similar testimony was offered by the Department of Justice, the American Bankers Association, and individual banks during our April hearings on the CBCT interpretive ruling. Subsequent to those hearings, the May 9, 1975 modification to the Customer-Bank Communication Terminal (CBCT) ruling was issued to insure that CBCT developments were proceeding under careful control and close scrutiny, that the public was assured of adequate safeguards against wrongful or accidental disclosures of confidential account information, and that no anti-competitive activities would be permitted.

Clearly, the exercise of regulatory control over National Bank CBCT developments, coupled with the valued cooperation of the Antitrust Division of the Department of Justice, has been effective to date. A total of 30 banks have filed notices of intent to operate CBCT's as of July 10, 1975. No individual, institution or group has been able to show any injury as a result of the limited CBCT activities.

Nor is the Commission in danger of being preempted by these experiments. Rather, the Commission should be able to derive substantial benefits from the real world experiences gained from live operations of EFTS by banks in the marketplace.

Temporary measures, such as the 90 day moratorium of Section 202, have a propensity to live on beyond the accomplishment of their intended purpose. Should the Commission fail, for any reason, to satisfy Congressional concerns within the 90 days, the period could be extended, thus adding to the uncertainties surrounding EFTS development.

Since there is no real need for a moratorium and since the results of such retarding action would effect a disservice to the public and innovative institutions alike, I must reaffirm my opposition to the proposed 90 day moratorium.

Section 203 sets forth a staggering list of tasks to be completed by the Commission during its initial 90 days of life. The report required by Section 203 addresses legislative requirements, monitoring, development of evaluation criteria and "means to insure a uniform system of experimentation." Several problem areas arise within this section, not the least of these is the nature and magnitude of the tasks assigned by Congress. This report seems as complex as the final one which Congress believed would take the Commission two years to prepare. I am troubled by the charge for the Commission to "monitor" all experimentation, given the earlier reference in Title II to "monitor and control."

It is my understanding that Congress intended that the EFTS Commission be an investigative and reporting agency not a regulatory one.

It is particularly difficult to expect comprehensive and complex recommendations to be developed by the Commission during its formative phase, even before the chairperson has had an adequate opportunity to assess the broader issues, scope and problem, assign priorities consistent with Public Law 92-495, and allocate resources.

It may be appropriate and prudent, however, to charge the Commission during the early stages of operation to report its views to Congress on the need and possible nature of an interim regulatory posture that might be adopted by the regulatory agencies during the lifespan of the Commission. Such a report could provide welcome guidance for Congress and regulators alike during this very preliminary phase of EFTS development.

The concept of "a uniform system of experimentation" suggests a commonality of approach, conduct and evaluation which is wholly incompatible with sound, well controlled experimentation. To be of value to the public, Congress and the industry, experimentation must be encouraged and allowed to flourish without massive governmental intervention or excessive uniformity. The concept of uniformity conflicts with the degree of creativity and willingness to take risks to achieve a potential reward in the marketplace that has so clearly benefited the American economy over nearly 200 years.

I am confident that the intent of Section 203 was to aid rather than preempt the Commission, but the apparent result conflicts with that intent.

In summary, Section 201 is excellent. Section 202 (a) should delete reference to "control". Section 202 (b) should be deleted and subsection (c) relettered as subsection (b). Section 203 might be restructured to reflect "recommendations for the guidance of Federal regulatory agencies" in place of legislative recommendations, eliminate the control implications and delete reference to a "uniform system of experimentation." Your objectives could thus be satisfied without significant danger to the public, the Commission, or the financial service industry. EFTS would be encouraged to develop in a highly competitive, experimental environment under the close and effective control of the accountable regulators.

Mortgage Disclosure Requirements

I would now like to address the issue of mortgage disclosure as raised in Title III of H.R. 8024, specifically, the purposes of this measure and some of the problems which I comprehend within its present provisions. The stated purpose of this proposed enactment is "to provide the citizens and public officials of the U.S. with sufficient information to enable them to determine which depository institutions are filling their obligations

to serve the housing and business needs of the communities and neighborhoods in which they are located". My understanding of the background of this and similar legislation is that the proposed system of reporting and public disclosure of data on savings deposits and mortgage lending is intended to affect positively the flow of mortgage funds from financial institutions into those sectors of metropolitan areas which have been and are experiencing physical deterioration and decay.

The complex problems of urban decay are clearly outside the expertise of the Office of the Comptroller of the Currency; however, from our knowledge and understanding of the purposes and practices of national banks we may be able to provide some insights which will assist this Committee in consideration of H.R. 8024.

The provisions of H.R. 8024 seem to proceed from the premise that by endeavoring to correlate the geographic source of a depository institution's savings deposits with its geographic placement of residential and commercial real estate loans, it is possible to make a fair and objective evaluation of how effectively that institution is serving the community in which it is situated. In terms of national banks particularly, I find this premise faulty for a number of reasons. Let me briefly describe a few of the principal reasons.

First, commercial banks service functions to a community span a multitude of deposit and lending functions far broader than the savings deposit and mortgage lending functions contemplated in the reports to be submitted under the terms of this

Bill. Commercial banks are typically the principal providers of business credit in a community, thus contributing importantly to the process of job creation, from which salaries and wages are derived that make possible home ownership and the satisfaction of other personal aspirations.

Similarly, commercial banks typically make an important contribution to community development (and for that matter neighborhood development) through their regular investment in the debt securities of municipalities and other bodies. The proceeds from such debt offerings are utilized in funding public institutions such as schools, recreational centers and community health centers. Here again the narrow focus of H.R. 8024 would take no account of this important financial service to a community.

Looking more narrowly at the contribution which a particular bank may be making with respect to financing home ownership in a community or neighborhood, it would be essential to take account of an institution's lending activities to building contractors, real estate developers and to the completion of specific projects through interim construction lending. Here again it seems to me that the reporting focus of H.R. 8024 would fail to pick up this activity which is most important to a balanced understanding of service to a community.

Second, I believe that H.R. 8024 proceeds on an unrealistic impression regarding the operations of deposit financial institutions in assuming that there is, or in fact, should be an absolute

geographic correlation between the receipt of deposits and placement of loan proceeds. The savings deposit function and the mortgage lending functions are separate and distinct services, each of which is valuable to a community. The markets for these services are often quite different and certainly the criteria for providing these services to individual customers are distinctly different and must remain so.

With respect to the savings deposit functions particularly, the provisions of H.R. 8024 could lead to some seriously mistaken impressions. Not infrequently an individual saver chooses a depository institution or branch of a depository institution which is conveniently situated in reference to that individual's place of employment. In those cases it is quite likely that the account will be carried with the employment address of the depositor rather than the residential address. To collect savings deposit data on this basis could lead to very real misunderstandings as to the real geographic source of these deposits.

Third, because the reporting system proposed in H.R. 8024 is, as I understand it, seeking information which will permit the public and public officials to be better informed with respect to the problems of urban decay, I must observe that this reporting system would fail completely to reveal those sectors, other than mortgage lending dis-investment, which contribute to this problem. While, as I have indicated we presume no expertise in this area, our own review of studies which have been made with respect to

the problems of urban decay seem to indicate that mortgage lending dis-investment is, in fact, one of the last events to occur in a long series of events in connection with creation of geographic sectors evidencing severe physical deterioration. Other factors which are typically present are the sharp decline in public services including sanitation, police and fire protection, and building code enforcement. Normally there is a withdrawal of fire and casualty insurance services. Likewise the policies of governmental agencies with respect to the insuring, guaranteeing, and the secondary market purchases of residential mortgages can affect the trend of deterioration in a particular neighborhood. None of these factors would be taken account of in the type of survey and disclosure contemplated by H.R. 8024. Indeed, to develop a reporting and disclosure system which could encompass all of the factors and activities which I have enumerated, and to acquire that data on a universal basis for the U.S. deposit financial system would seem to entail such enormous expense that it would probably fail on a cost-benefit analysis.

For these and other reasons I must recommend against the enactment of H.R. 8024.

Consultant's Review of the Office of the Comptroller of the Currency

The Haskins & Sells Study, which commenced about a year ago, was the first comprehensive review of the Office of the Comptroller of the Currency in its entire 112 year history. The Study began

with the identification of the basic objectives of National bank supervision and regulation. It focused on a review of the present OCC policies, practices, and procedures; evaluated the extent to which they achieved the stated objectives; and developed recommendations for improvement of present activities in order for the Office to achieve its objectives more effectively and efficiently.

The review dealt with the:

1. Examination and supervision function, (including bank reporting requirements, examination procedures, an early warning detection system, and enforcement and compliance powers);
2. Corporate regulatory function (including activities associated with charters, branches, mergers, conversions, capital changes, name and location changes, trust powers, subsidiaries, and ownership or management changes); and
3. The internal organization and operations of the OCC (including organizational structure, planning, human resource activities associated with recruiting, manpower planning, employee relations, compensation and benefits, training and personnel development, information processing, operations review, and advisory services).

The Study has been completed and Haskins & Sells is in the process of rendering its report. I have set the date for release of the report as the first week of August. Copies of the report will be distributed to the entire membership of Congress, other financial regulatory agencies, all National banks, and other interested parties.

But given the Committee's present interest in the Study, I am providing the following general summary of the key recommendations from the Haskins & Sells Study.

Examination and Supervision Function

Recommended improvements for this function center on the updating of our examination procedures to match the level of sophistication within the banks we examine. To accomplish this objective, increased emphasis will be placed upon supervision techniques designed to make banks manage themselves better. We will review bank management techniques for validity and focus our examination on testing the bank operations for compliance with such management techniques.

Greater emphasis will be placed upon evaluating bank policies and procedures, bank management capabilities, bank internal controls, and bank reporting techniques. From our side, we will sharpen our examination tools by providing updated procedure manuals and guides, more effective recruiting and training procedures, identification of specialized activities and talents needed to deal with specific kinds of problems (such as those

associated with sophisiticated EDP operations), and improved communications. We will no longer expend the talent of our manpower on detailed verification procedures, unless they are called for in special situations. We will focus our attention on bringing modern techniques to the routine tasks of examination procedures and on providing the time our examiners need to focus their attention on areas of exposure and risk.

Haskins & Sells has confirmed our need for an early warning system to detect changing situations in the banking industry and in individual banks. We will therefore be developing a National Bank Surveillance System for use in our Washington and Regional offices. It will be based upon reports furnished by banks and routinely tested by us and will provide us with leading indicators of conditions that might trigger an inquiry into an individual bank, or possibly cause us to investigate a condition common to the industry for which a policy consideration must be made for use throughout the Office.

We will also be strengthening our enforcement and compliance capabilities to deal more effecitvely with banks which pose threats to the soundness of our banking system.

Corporate Regulatory Function

The major recommendations for improving the effectiveness of the Office in this area are centered in delegating more of the routine tasks associated with individual banks, such as branching, name and location changes, capital changes, and the like to

regional offices and permitting Washington to focus on Office-wide policy decisions and those activities such as new charters, mergers, and conversions which affect the entire banking system.

To accomplish the impact of these types of recommendations, improvements will also be needed by providing more formal and written policies and decisions guidelines, improved application forms, instructions, and processing procedures, and, of course, effective coordination and communication.

Internal Organization and Operations

To accomplish improvements in the examination and corporate regulation functions, improvements are also needed in our internal organization and operations.

Recommendations in these internal areas will require a reorganization of our personnel between Washington and the regional field offices. Primarily, the reorganization will reinforce our capabilities in Washington to track developments in the banking industry for both the examination and corporate regulatory areas.

A more formal planning process will also be established to plan, coordinate, and communicate the unified activities of the Office. These activities will be based upon the decisions of a senior policy-making group within the Office. The process will identify strategic objectives and then set into motion the operational changes to meet the objectives.

We will have a substantial upgrading of our human-resources capability of the Office. We are a people-intensive organization and thus we must pay attention to their activities. There will be more effective training, as mentioned earlier; but we will also have substantial improvements in our manpower-planning process, recruitment activities, employee relations, compensation and benefit programs, and personnel development programs.

Internal improvements will also be made in the processing of information, both regulatory and admininstrative, within the Office.

A major new effort of the Office will be the adoption of a program of operations review. More than just a quality control check, this program, to be headed by a senior level executive, will provide continuous evaluation of all activities of the Office.

In our approach, we planned to have the contractor conduct its study, formulate and present recommendtions, and present plans for implementing the recommendations. As previously stated, Haskins & Sells is finalizing its report containing recommendations. They are also presenting for the consideration of my office a program for implementing the recommendations. We plan to move ahead full-speed to commence implementation in a planned and orderly fashion. It will not be an easy task. It will involve not only the commitment of resources from the contractor,

but heavy direct involvement of many people within our organization. To an extent, the contractor will play the role of advisor to our people performing the new procedures so that in due course we are fully operational on an independent basis.

I have purposely requested Haskins & Sells to formulate plans for implementation giving particular attention to accomplishing major proportions of implementation over the next nine to eighteen months.

Within the first 90 days of the Study, I requested Haskins & Sells to furnish me with initial impressions of the Office. As a result, we identified several areas where improvements could be commenced without waiting for the completion of the Study. A Task Force of commercial bank examiners was formed last December to work with Haskins & Sells representatives to translate their suggested improvements into a major revision of the examination handbook. The first draft of this handbook revision (consisting of some 31 chapters) will be ready for field testing and modification within the next month. Similar task forces were formed of trust and EDP examiners and the first drafts of their manuals are nearing completion.

In the area of information processing, we commenced implementing improvements early last fall. A senior committee of information users within the Office was formed to direct our efforts in producing critically needed information on a timely

basis. The committee gave a needed structure and discipline to this internal activity, and improvements have resulted.

In the area of internal organization structure and the human resource activities of the Office, we have likewise commenced implementation. This week I announced a number of top level reassignments necessary to start the major implementation program.

Reforms Adopted Subsequent to United States National Bank Failure

You have requested that I summarize both the administrative and legislative reforms which our office has initiated as a result of our experience with U.S. National Bank, San Diego, California.

1. Examiners were instructed to prepare at each examination a schedule of violations of law, such as the statutory lending limitation (12 U.S.C. 84) or the limitation on loans to affiliates (12 U.S.C. 371c), for comparison to previous examinations whether or not these violations were cured during the examination. Recurrent violations become the subject of cease and desist proceedings by the Comptroller's Office.

2. A regulation including letters of credit within obligations subject to the lending limits of 12 U.S.C. 84 was published in the Federal Register on August 9, 1974. This regulation had been in the drafting stage prior to the closing of USNB, but had been delayed due to the problems of achieving uniform treatment

of state and national banks. The final regulation was published in similar form by the Federal Reserve and the FDIC this past summer. The misuse of letters of credit at USNB was thoroughly explored at this Committee's hearing of November 27, 1973. This regulation, if in effect during the last four years, might have eliminated one way in which the Smith related companies obtained funds from USNB. A copy of the final regulation is attached hereto.

3. The aggregate amount of outstanding standby letters of credit was required to be publicized quarterly as part of the regular report of conditions and also in the annual financial reports mailed to shareholders.

4. Our examiners were reminded of the importance of satisfactory credit information about borrowers being retained in the bank files. The lack of such information was chronic at USNB. I personally have mentioned this subject at many staff conferences through the country. Large commercial loans of the sort involved at USNB should be supported by audited financial statements for the last three years, including profit and loss figures, and by information about the officers and owners of the company. When a borrower is a public company, its public filings with the SEC for the last three years should be retained in the bank's loan files and reviewed by our examiners. These procedures are not new, but they are being reemphasized.

5. Regulations were issued in May 1975 requiring each director and principal officer at every national bank to maintain a current file at the bank, identifying every business enterprise in which said person, spouse or minor child has a legal or beneficial interest of 10 percent or more, or to which said persons owe or are owed $100,000 or more. In addition, such file must identify any loan transaction from the bank which benefits such an enterprise, but which does not appear on the books of the bank as having been made to such enterprise. Any significant change in the foregoing information must be filed within 30 days of its occurrence. A copy of said regulation is attached.

6. An interagency task force was formed to draft legislation to provide additional enforcement tools and penalty provisions for violations of the banking laws and to clarify and tighten certain substantive rules. This task force has been exploring the following areas and expects to submit draft bills on the following subjects:

A. Tightening of the laws restricting loans to affiliates of banks and to insiders.

B. Improvements to and speeding of the enforcement provisions of the Financial Institutions Supervisory Act of 1966 (cease and desist).

C. Money penalties for violations of banking laws. Other possible legislative recommendations under consideration by our Office are:

A. Conferring authority on the Comptroller to commence derivative-type civil litigation on behalf of a bank for money damages against wrongdoing officers and directors.

B. Requiring prior approval by the appropriate banking agency of changes in ownership of controlling stock interests in banks.

7. The complete reorganization of the Office structure and substantive approach to bank examination embodied in the Haskins & Sells report can be related to the San Diego experience. Although I had decided before USNB failed to commisson such a study, the traumatic months leading up to October 1973 cemented in my mind the necessity for a thorough-going overhaul of the existing procedures.

The complete description of the reorganization plan resulting from recommendations by Haskins & Sells' report will be in the Committee's hands in early August and will constitute the most complete answer to the question of what we learned from USNB.

Franklin National Bank

In your letter of June 20th, you requested a "full and complete report" on Franklin.

In anticipation of some of your questions, I have prepared this section of the testimony using the question and answer format.

What had been the bank's history over the ten years prior to its failure?

Franklin was chartered by the Comptroller's Office in 1926 and in 1969, the Comptroller approved the corporate reorganization under which shares of Franklin were acquired by the Franklin New York Corporation. At December 31, 1973, Franklin was the 20th largest bank in the United States with total resources of $5 billion, total deposits of $3.7 billion, and total loans of $2.4 billion. Franklin had a main office in Manhattan and 103 domestic branches, most of which were located on Long Island.

During the five-year period of 1964 to 1969, Franklin had no serious problems or extraordinary deficiencies. The troublesome problems with the bank started about 1969.

On a balance-sheet basis, Franklin experienced a steady growth in resources from $1.5 billion on 12/31/64 to $5.0 billion on 12/31/73. The growth of Franklin's resources and liabilities was not in itself an indication of unsound condition; however, the continuing inability to manage successfully those resources and liabilities led to the bank's deteriorating condition. Sufficient quality, profits, liquidity, and general confidence in Franklin simply were never developed. As a result, it was in no position to stand and survive the economic conditions which developed and pressed upon all banks in 1973/1974.

Franklin's capital funds grew by only $76 million in the 1964/1973 period while its resources grew by $3.5 billion. Twenty million of that nominal capital growth was from the issuance of stock in 1967 and only $56 million from retained earnings.

During its last two years, when the bank's most significant asset and funding growth occurred, its capital funds showed essentially no growth, and its reserve for bad debts declined by $2.6 million.

In spite of rapid growth in the latter years of its existence, Franklin was not successful as an earner. Its old, accumulated assets of poor quality and its management errors left it without the income ability to command confidence. During its last four years, Franklin's net income declined steadily from $21 million in 1970 to $17 million in 1971 to $13 million in 1972 and to a marginal $12 million in 1973. Of that final $12 million, $7.7 million was from foreign exchange trading income which was an additional display of final efforts to override old unsolved problems.

Our bank examiners measure asset quality as a percentage of classified assets to gross capital funds, with 40 percent being a traditional benchmark for asset problems requiring additional attention. In the reports of examination from 1964 to 1969, that classified percentage exceeded 40 percent only two times, 46.2 percent in April, 1965, and 42.3 percent in October, 1966. By September, 1969, it had declined to 16.2 percent. From August 30, 1970 forward, that percentage remained consistently over 40 percent and it was not substantially reduced. It was 58.9 percent in August of 1970, and it was 59.1 percent when the bank was last examined on May 14, 1974.

The final 59 percent was certainly not evidence that the bank was insolvent but the persistence of these high percentages was evidence of management's inability to rid the bank of asset problems which were bearing heavily upon its earning and confidence problems.

While the bank's classified asset percentages were not publicly known, its asset losses were and those losses became extremely heavy for its declining earnings in 1973. The bank had managed to maintain its reserve for loan losses at $31 million during the three years from 1969 through 1971, not through charges to current earnings alone but also through charges to retained earnings. Then in 1972 and in 1973 its net loan losses exceeded its charges to earnings and its reserves declined to $30 million and finally to $27 million.

Franklin's net return on assets declined from 0.63 percent in 1970 to 0.26 percent in 1973. The average return on assets for 47 peer group national banks ($1 to $5 billion) was 0.92 percent in 1970 and 0.74 percent in 1973. By 1973, Franklin was retaining only 3.9 cents of pretax income for each dollar of revenue. The average figure for the 47 peer group national banks in 1973 was 14.8 cents.

While total interest income from loans remained relatively stable, Franklin's total interest expense on deposits increased from $97 million in 1969 to $235 million in 1973.

Franklin's "percentage change in net income from the previous year" was +30.9 percent, 1968 to 1969. For the 1971 to 1972 comparison, this percentage was -38.9 percent.

In conclusion, Franklin had a history of a marginal existence as a New York City bank with poor earnings and an unimpressive management reputation that ultimately caused a loss of confidence in financial circles.

Most damaging of all, however, was Franklin's incredible expansion by the use of borrowed funds in 1973. At the time we examined the bank in November, 1973, about 50 percent of the bank's liabilities were in the form of volatile, interest-sensitive liabilities. Between our examination in December, 1972, and the one in November, 1973, Franklin had an increase in assets of 29 percent. During the same period its demand and savings deposits declined 5.5 percent. Thus this excessive expansion in assets was almost exclusively supported by short-term money market funds.

Several questions arise as a result of the ten year review of Franklin's activities. Should the Comptroller's Office have taken more affirmative action with Franklin?

In retrospect, the Office did not act aggressively enough to make Franklin put into effect the measures required to correct the situation criticized in the examination report. For example, we might have used our approval of new branch locations more

skillfully as leverage to encourage Franklin to raise additional capital and to make other improvements in its performance.

Should the present occupant of the Comptroller's Office have personally involved himself in Franklin's problems at an earlier date?

An objective assessment, benefited by "20-20 hindsight," might indicate that meetings should have been held with the bank's management during the summer or fall of 1973; however, even at that point the explosive danger of the combination of declining earnings and a heavy reliance on short-term interest-sensitive deposits was not sufficiently recognized.

When did the Comptroller become directly involved with Franklin and what steps were taken to deal with the problem?

An examination of Franklin was started on November 14, 1973. This examination revealed the extraordinary growth of the bank, supported by the purchase of short-term volatile funds, and the report reconfirmed the need for additional capital. As of November 14, 1973, total resources had increased by 29 percent since the last examination, and yet the capital of the bank had been increased by less than 1/2 of 1 percent. The report also showed a substantial depreciation in the securities accounts.

It was apparent that the bank's poor earnings, potential loan losses, and extended foreign exchange position might easily cause a loss of confidence in the bank, which in turn would result in a serious and overwhelming liquidity crisis. In late

February, Regional Administrator Van Horn and Examiner-in-Charge Lake met with me in Washington to discuss the nearly completed examination report. At this time Mr. Van Horn was directed to conduct a meeting with Franklin's Executive Committee and to obtain from the bank a written plan directed at improving the bank's condition, with emphasis on the reduction of all short-term borrowings, the establishment of a clearly defined written loan policy, and a clear definition of the management responsibilities of the senior officers of the bank.

On March 29th this meeting was held and bank officials agreed to prepare and implement the plan. Thereafter, a number of meetings occurred between me and bank officials, especially Mr. Norman Schreiber who had recently joined Franklin.

Why were their plans not successful?

There was a series of events that prevented Franklin's management from implementing the plans.

On April 18, 1974, Franklin announced net operating income for the first quarter of 1972 of $79,000 or 2¢ per share. The comparable earnings for the first quarter of 1973 were $3,123,000 or 68¢ per share.

On May 1, The Federal Reserve announced its denial of Franklin's bid to acquire Talcott National Corporation.

During the week of May 6, 1974, the Comptroller's Office learned from Franklin that severe losses had occurred in Franklin's foreign exchange operation.

The primary reason, however, that management never had the opportunity to implement their new plans was the money market. Short-term interest rates were spiraling upward at a rapid rate. The sellers of funds began to move to quality, and for the first time a tiered market developed in which the sellers of short-term funds demanded premiums from all but the largest institutions and flatly refused to sell funds to institutions whose performance was seriously below par. As confidence in Franklin declined, the bank was literally frozen out of all sources of short-term funds. To a bank such as Franklin, which depended so heavily on purchased funds, this situation meant certain death.

In a normal money market environment, Franklin might have been saved. But given the highly selective character of this market, there was no hope. We were not dealing with a conventional balance sheet insolvency but with a potentially fatal liquidity crisis.

In a tiered money market, one thing that a bank with excessive reliance on short-term borrowed money cannot afford to lose is that market's complete confidence in the bank, and the events of April resulted in an erosion of confidence.

On Friday, May 10, Franklin announced that it would not declare its regular quarterly dividend. During the same weekend, Franklin announced that extraordinary foreign exchange losses had been discovered, and requested the SEC to suspend trading in the

bank's stock. There was general agreement that the announcement would cause a dramatic decline in the ability of Franklin to borrow funds when the bank opened on Monday morning.

What steps did the Comptroller of the Currency take over the May 10 weekend?

A series of meetings and discussions was held over the weekend with representatives of Treasury and the Federal Reserve Board, and senior officials of the New York Federal Reserve Bank.

As a result of the weekend's activities, the Federal Reserve agreed to advance funds to Franklin as needed, within reasonable limits of acceptable collateral.

Contacts were made with representatives of various New York banks to explore the possibility of putting together a quick salvage merger. These inquiries were unsuccessful.

Discussions were held with members of Franklin's management to plan steps to restore confidence in Franklin and to attempt to slow the deposit run-off.

I initiated telephone discussions with Mr. Sindona. He agreed to assign to The Honorable David Kennedy, former Secretary of the Treasury, his power to vote the shares of Franklin Corporation held by the Sindona-owned FASCO Corporation. Mr. Sindona also offered to support additional capital in Franklin through guaranteeing a rights offering of the stock.

The result of all the meetings and discussions held over the weekend of May 10 was a consensus decision to attempt to avert an anticipated run on the bank. It was feared that if Franklin failed, such a failure would have set in motion a panic throughout the domestic and international banking systems.

What happened between the weekend of May 10, 1974, and July 2, 1974, when formal notice was given to the F.D.I.C.?

Our fears of a major liquidity crisis were quickly confirmed on Monday morning, May 13, and the deposit run-off thereafter was immediate and steady. Within 21 business days, Franklin suffered a deposit loss of $1 billion in deposits. Our goal was to protect all depositors and shareholders and, if possible, to save Franklin through a private market solution, without long-term federal assistance. Following the May 10 weekend, we moved ahead on several fronts.

Steps were taken to firm up Mr. Sindona's verbal offer to me to guarantee a rights offering of additional stock up to an amount of $50 million. His offer was presented as a formal written proposal to the Board of Directors of the Franklin National Corporation and was accepted by the Board, subject to later shareholder approval. While such an infusion of additional capital would have fully restored the losses suffered through the unauthorized and unrecorded contracts in foreign exchange, it was never my belief that this action standing alone would be adequate to rebuild market confidence in Franklin to a level that would permit the time for solution of its basic problems of liability structure, asset quality, overhead costs, and earnings.

Clearly the quickest way home to safe harbor was to find a bank of size and high quality willing to acquire either a major ownership position in the Franklin National Corporation or the assets of the bank through a purchase and assumption transaction. In exploring this alternative it was essential that such discussions be conducted by Franklin's officers or a representative designated by management. I suggested the Honorable David Kennedy as an ideal individual to conduct such discussions.

By reason of his acceptance of the sole voting power over the FASCO-held stock of the Franklin National Corporation he was to be an important voice in the future direction of the bank. His vast banking experience, his broad acquaintanceship and excellent reputation in the worldwide banking community offered unique qualifications for this most complex assignment. Likewise, my own high regard for this man, with whom I had served during his term as Secretary of the Treasury, satisfied me that if such a commercial arrangement was realistically achievable, he could put it together.

Secretary Kennedy accepted this assignment and devoted much time and effort to securing a major institutional partner. Based on discussions which I had previously conducted with the major New York banks, Secretary Kennedy and I agreed that the most likely prospects would be among major foreign banks to which Franklin's sizeable territorial base in the New York metropolitan market could be expected to have some real appeal.

At the same time, I requested and obtained agreement from the banks comprising the New York City Clearing House Association to carry out an in-depth analysis of Franklin's operation. This operation was carefully coordinated with the Antitrust Division to guard against any activities that might violate the Federal antitrust laws.

My purpose in seeking this assistance from the New York City banks was two-fold. First, I wanted the knowledgeable judgment of major bank management as to whether or not Franklin was a redeemable entity, assuming the attainment of our private-sector objectives. Second, recognizing that I might ultimately have to decide that the only realistic salvage recourse was with the F.D.I.C., I concluded this evaluation project could contribute importantly to identifying the information which prospective acquirers would need to participate intelligently in an F.D.I.C. receivership sale. In further support of this fail-safe alternative, I instructed our New York Regional Office to begin the task of assembling data, schedules, leases, and documentation that might facilitate the F.D.I.C.'s efforts.

By the first of July, based on discussions with Secretary Kennedy indicating no significant interest in Franklin from foreign banking institutions on a commercial basis, and taking account of the somber appraisals I was receiving from the New York Clearing House project, I sadly concluded that the broad requirements of the public interest demanded that I formally request the assistance of the F.D.I.C.

At this point let me acknowledge frankly that there has been criticism of the fact that I did not move immediately in the wake of the events of the May 10 weekend to formally request the F.D.I.C. to initiate discussions aimed at achieving an assisted purchase and assumption transaction such as was used in the case of the U. S. National Bank of San Diego. My decision not to take this step in May, 1974, was a decision on which I believe reasonable persons could fairly disagree.

In summary, the reasoning supporting the decision which I made was as follows:

The immediate problem we faced was not a typical balance sheet insolvency, in which the amount of the liabilities clearly exceeded the value of the assets. Instead, we had an institution suffering a serious liquidity problem directly attributable to a sharp decline in institutional and market confidence in this bank. Thus, I concluded that, if appropriate steps could be taken over a reasonably short time to restore confidence, it might well be possible to cure the liquidity crisis to a point where the time would be available to treat successfully with the bank's more fundamental problems.

What were my reasons for seeking then to avoid a governmentally-supported salvage through the facilities of the F.D.I.C.?

First, Franklin had several thousand shareholders and debenture holders, many of them middle-income residents of Long Island, who deserved my best efforts to preserve some remaining

value in their investments. Experience convinced me that the prospects for their salvaging even minimum values after a receivership sale were quite remote.

Second, an F.D.I.C.-assisted transaction for an institution of this size must of necessity take a considerable period of time to consummate. A principal reason for this protracted time period is the fact that public funds are used. The F.D.I.C. must assure that the highest possible bid is obtained to minimize the net utilization of the Corporation's insurance reserves. This requires that every institution for which such an acquisition might be considered a reasonable undertaking be contacted and that a uniform bidding agreement be developed in consultation with the institutions evidencing a serious interest. Additionally, such procedures are necessary to obtain a result free of any questions concerning favoritism towards particular institutions. Recognizing that Franklin's difficulties were creating troublesome conditions in both domestic and foreign financial markets, the public interest appeared best served by the speediest route to solution. I believed that route to be via private, non-governmental arrangements.

Third, I was deeply concerned that a second major bank receivership in the brief span of twelve months would have a most adverse effect on the ability of other banks to obtain capital. All bank regulatory agencies were troubled by the increasing difficulties banks were encountering in raising capital at reasonable cost.

Fourth, I was genuinely convinced at that time that there was a reasonable prospect for success in seeking a private-sector solution. I certainly recognized it was no sure thing and that my decision involved some calculated risk: however, knowing the considerable period of time that would be required by a governmentally-aided solution, I concluded for the reasons stated above that taking some comparatively brief additional time to explore private alternatives was fully justified.

Furthermore, I recognized that even while we were seeking private-sector solutions it would be possible to take some actions helpful to an F.D.I.C. purchase and assumption transaction should our efforts fail. I shall touch on these actions later in this statement.

Those who have not been involved in transactions such as U.S.N.B. might validly inquire why it was not possible to have the F.DI.C. process moving foward in exact parallel with our private sector explorations. This simply is not possible. To carry out its purposes the F.D.I.C. must contact and meet with banks to discuss the real possibility of a receivership, and the plans for a sale of assets and an assumption of liabilities with the F.D.I.C. acting as receiver. Once those discussions have ensued, potential acquirers understandably quickly lose interest in a private, commercial transaction which would involve greater attendant risks to their shareholders.

Our efforts to obtain a resolution of Franklin's problem before resorting to an F.D.I.C.-assisted salvage took place on several fronts.

A search was immediately initiated for a new chief executive officer, whose reputation in domestic and international financial circles would begin the process of restoring confidence. This search culminated in the employment of the Honorable Joseph W. Barr.

Mr. Barr, who is well known to many members of this Committee as a former colleague, had a distinguished background in the fields of government and finance, having served as Chairman of the F.D.I.C., Under Secretary and Secretary of the Treasury Department, and as Chairman and Chief Executive Officer of American Security and Trust Company of Washington, D.C. He was well and favorably known in foreign financial institutions, and a man with whom I was confident we could work effectively under most demanding conditions. My confidence in him was fully justified by his performance. Without him and the qualities of integrity, courage, and decisiveness which he brought to bear on the myriad of problems, I frankly doubt that the successful result in behalf of Franklin's disposition could have been achieved.

The discovery of major problems in the bank's foreign exchange department resulted in the discharge of most of the technically qualified officers in this area. To assist the bank in

treating with the continuing serious problems in foreign exchange, we located and secured the employment of Mr. Edwin Reichers, a highly qualified and respected foreign exchange expert.

What happened between the dates of formal notification to the F.D.I.C. on July 2, 1974, and the sale of Franklin to European-American on October 8, 1974?

We continued to move ahead on several fronts in an effort to restore confidence in Franklin and to stabilize its situation. On July 11, 1974, an arrangement was reached whereby the member banks of the New York Clearing House would lend fed funds to Franklin in an amount totaling $200 million.

In an effort to alleviate further liquidity problems, I requested a meeting of representatives of 25 large U.S. banks to discuss selling Franklin's portfolio of Euro-currency loans. It was our hope that at least $100 million of these credits could be sold and Franklin could reduce its reliance on Federal Reserve borrowings. This proved to be an unsuccessful effort because of the interest rates on these credits and because of the liquidity problems of all large banks at that time.

As a result of continuing negative announcements, contin ng deposit decline, and management's continued inability to reduce the loan portfolio, on September 30, Franklin's total borrowings from the Federal Reserve Bank of New York exceeded $1.7 billion. By the end of September, total deposits were rapidly approaching

the $1 billion mark and total other liabilities were close to $2 billion. The bank was unable to retain any maturing certificates of deposit or other money market liabilities.

In September, Mr. Barr presented the regulatory agencies a plan by which, with substantial assistance from the F.D.I.C., Franklin would shrink, give up most of its national and international business, and become a Long Island bank.

Mr. Barr also suggested that in the event a takeover of Franklin became necessary, it would be beneficial to the interests of the shareholders and to the competitive situation to widen as much as possible the list of potential purchasers. The greatest obstacle to this was the statutory situation which limited the list of potential U.S. buyers to New York State chartered institutions and national banks located in New York. Mr. Barr requested that not only for this case, but also for the future, Congress should act quickly on legislation which would permit the purchase and operation of banks across state lines where necessary to prevent the probable failure of a large institution. Time did not permit the adoption of such legislation before the end came for Franklin, but it is hoped that the Congress will soon provide for such a situation.

I requested the investment banking firm of Blyth Eastman Dillion & Co. to advise us concerning Mr. Barr's proposal. On October 3, the firm advised that the prospects of Franklin's achieving financial viability as an independent banking institution were highly unlikely.

Mr. Chairman, I would be remiss in recalling the events of the Spring and Summer of 1974 if I did not pay special tribute to the dedicated and competent efforts of Mr. Norman B. Schreiber and Mr. Raymond T. Andersen, two gentlemen who joined the senior management of Franklin in early 1974. Each came to Franklin from a long and distinguished career elsewhere in the financial community. Both gave the problems they inherited their best efforts, but time and events simply denied them a fair opportunity to bring about the necessary corrective results.

Based on all the facts available, including Mr. Barr's proposal which conceded that the bank could not survive without substantial massive government assistance, the Blyth Eastman Dillion report, and the negative reports by the New York Clearing House banks, I concluded that Franklin did not appear to be a viable institution.

On October 4, I wrote to the Federal Reserve Bank, briefly reviewing the situation, and asking for the Federal Reserve Bank's views with respect to its continued willingness to lend funds to Franklin. On October 7, the Federal Reserve Bank replied, stating that its emergency credit assistance to Franklin was based on public policy considerations arising from the responsibility of the Federal Reserve System as a lender of last resort and was designed to give Franklin and the Federal banking regulatory agencies concerned a sufficient period to work out a

permanent solution to the bank's difficulties. The Federal Reserve Bank also had concluded that the Franklin proposal of September 16, to the FDIC, did not offer a feasible means of achieving the continuation of Franklin as an independent, viable bank. The Federal Reserve Bank advised that it would not be in the public interest for that bank to continue its program of credit assistance to Franklin.

Based upon the continual, daily deterioration of the bank, which resulted in the further erosion of confidence both in Franklin and in the banking system, I became satisfied of the insolvency of Franklin. The Comptroller, as the official charged with the responsibility of determining insolvency and protecting the bank's depositors, is not required to wait until the losses he finds in the bank's assets are actually charged against the bank's book equity capital. The Comptroller's duty is to determine when a bank has reached the point that it will not be able to meet obligations to its depositors in the near future. It was impossible for Franklin to survive without further Federal assistance.

It simply was not in the best interest either of Franklin's depositors and other creditors or of its shareholders to wait for further deterioration in the bank's condition, especially when the alternative of the FDIC-assisted purchase of the bank at a price including a substantial premium for a going concern value became available. At 3 p.m. on October 8, having become satisfied

that Franklin National Bank was insolvent, and acting pursuant to 12 U.S.C. 191, I declared the Bank insolvent and appointed the FDIC as receiver.

In order to protect all of the depositors of Franklin, the FDIC moved immediately to accept bids from several major New York banks upon a pre-negotiated contract which provided full protection for all Franklin depositors and other normal banking creditors. The winning bidder was the European-American Bank and Trust Company, a federally insured, New York State chartered institution owned by six large European banks. The following day every banking office of Franklin was opened at the regular banking hour by the European-American Bank. All depositors in Franklin, including holders of certificates of deposit, savings accounts, time accounts, and checking accounts, automatically become depositors of the European-American Bank. The European-American Bank also assumed all existing liabilities to trade creditors of Franklin. The approval of the purchase and assumption transaction avoided any disruption in service for depositors and increased the chances of subordinate creditors for full repayment of their claims.

In summary, our number one goal was to protect the depositors and the banking system of this country, and that goal was achieved. By October 8, Franklin was no longer the 20th largest bank in the country but had become about the 46th largest bank. Of the 65 banks in its size category ($1 to $5 billion in deposits) Franklin had ranked 65th in earning power. This lack of

ability to generate earnings, combined with heavy reliance on purchased money, finally created a combination of circumstances which the bank could not bear.

The Franklin crisis was a liquidity crisis; however, we underestimated the rapidity with which a serious liquidity problem can become an insoluble liqudity problem when a marginal bank relies heavily on interest-sensitive, short-term funds, and there is a sudden "move to quality" by the money market participants.

Mr. Chairman, while the Franklin National Bank case is certainly an unhappy event in the annals of American banking history, we should nevertheless, observe that the highly professional support given to this Office by the Federal Reserve and the F.D.I.C. made possible the full protection of the bank's depositors and also contained matters so as to prevent any ripple effects elsewhere in the banking system. Both of these agencies, including, of course, the Federal Reserve Bank of New York, deserve the highest admiration of the public for outstanding performance in most demanding circumstances.

Security National Bank

The Committee has requested "a full explanation of the procedure utilized in the sale of Security National to Chemical Bank." In addition, the Committee asks to be advised of any

pending legal actions related to the sale in which the Comptroller's Office has been named a party and a summary of the legal issues involved.

To answer the second part of the inquiry first, the Comptroller's Office is presently not a party to any lawsuit involving the Security National Bank, or any officer, director, or shareholder of the bank.

In response to the first part of the question, I think it would be useful to the Committee not only to explain the procedure used in effecting the sale of the bank but also to highlight some of the events and considerations which led to the decision that an emergency existed, thereby triggering the procedure used, pursuant to 12 U.S.C. 181. As part of this background material, I have included a copy of the declaration of emergency issued January 18, 1975.

An examination of Security National Bank commenced June 24, 1974, and was completed September 25, 1974. At this time the bank had total assets of $1.86 billion. Classified assets totalled $171.9 million or 110 percent of gross capital funds. This figure consisted of $106.7 million of substandard assets, $53 million of doubtful assets and $12.2 million of loss assets. The quality of the bank's assets had evidenced a steady deterioration during the last three examinations. Classified assets as of the January 1973 examination totalled $93.4 million or 64 percent of gross capital funds. The October 1973 examination

reflected an increase in classified assets to $147.5 million or 97 percent of gross capital funds. Assets classified as losses increased from $3.3 million at the January 1973 examination to $12.2 million as of the June 1974 examination.

Between the January 1973 and June 1974 examinations the bank suffered a $174 million run-off in deposits. Meanwhile, loans during this period increased by $75 million. The combination of the loss of deposits and increase in loans created severe liquidity problems which resulted in a concomitant increase in borrowed funds. Short term borrowings reached a high in August 1974 with average daily borrowed funds of $330 million.

In 1972 Security merged with the Royal National Bank and the adverse effects of this merger had a continuing, adverse effect on the bank's earnings. Of the loans classified as losses $13 million or 41 percent of all loans classified as losses since the merger were acquired from Royal National Bank.

Upon completion of the June 1974 examination, the bank was placed on a weekly reporting basis in order that the Office could more closely monitor its condition.

On August 5, 1974, at my request, Patrick Clifford, chairman and chief executive officer of Security, and William Shea, director and counsel with the bank, came to Washington to discuss the condition of the bank as indicated by the ongoing examination of the bank. Mr. Clifford reported the difficulty in the bank's retaining deposits as a result of the anxiety in the Long Island

market due to the unresolved problems of the Franklin National Bank. This Office advised Messrs. Clifford and Shea of the heightened concern with respect to the bank's growing reliance on short-term borrowed funds and urged that every reasonable step be taken to improve the bank's liquidity and thus reduce the market reliance. Arrangements were made to have the bank keep the New York regional office advised of the institution's ability to reduce borrowed funds.

The examination was completed in early October and on October 17, 1974, members of the Comptroller's staff from Washington and New York met with the Board of Directors to discuss the condition of the bank. Through a personal representative, sent from Washington, the Board was informed of my deep concern about the condition of the bank, which resulted from too rapid growth built to a large extent upon expensive and unstable borrowed funds and high risk loans.

Because the bank was relying too heavily on the Federal funds market and other borrowings to support its loan commitments, the board was advised of my earlier instructions to the bank's chief executive officer to reduce these commitments through gradual reduction in size of the loan portfolio. Particular concern was expressed because several former sellers of funds had refused to sell the bank any additional funds and the continued ability of the bank to borrow appeared to be in jeopardy.

The Board was informed that the bank's capital, because of actual and projected loan losses, was inadequate. However, because market conditions and the condition of the bank itself created little hope for obtaining additional outside capital, the need for contraction to increase liquidity was deemed ever more important. The meeting concluded with a directive to the Board to formulate a thorough plan of corrective action and forward the plan to the Comptroller's Office by October 24, 1974.

On November 12, 1974, a meeting was held with members of the Board of Directors, senior management of the bank, and senior officials of the Comptroller's Office. The meeting was held in Washington to review the bank's borrowing requirements, prospects for a reduction in borrowed funds, and status of loan and deposit activities. Because of the recent resignation of two senior officers, the need for a senior executive officer was also discussed. In addition, considerable time was devoted to exploring the prospects of a merger.

On December 9, 1974, what became the final examination of the bank commenced. As of this examination, the bank had total assets of $1.7 billion, loans of $1.2 billion and deposits of $1.3 billion. Assets subject to classification aggregated $233.5 million or 156 percent of gross capital funds, of which $67.6 million was classified as doubtful and $24.2 million was classified as loss.

On January 8, 1975, another meeting was held with members of the Board of Directors and management to discuss the condition of the bank. The prospects for turning the bank around depended heavily upon the effect of the CPA report, which would be out in the near future. Discussion commenced with our then current evaluation of the bank's loan portfolio. Our conclusions, which were not disputed by the bank's management, were that existing loan loss reserves plus year-end earnings would be completely wiped out by the likely loan loss chargeoffs. Since these facts would be revealed in the certified public accountant's year-end report, it was generally agreed that the bank's diminishing ability to attract short-term funds would be materially worsened. Short-term interest rates were continuing at a high level which adversely affected efforts to improve the bank's condition in two important respects: (1) operating expenses continued at an abnormally high level, seriously impairing the bank's ability to improve earnings, and (2) the discounting necessary to sell assets in this high-rate environment would have produced capital losses of such magnitude as to impact fatally the bank. Faced with this grim appraisal of the bank's prospects for the present and foreseeable future, it was the consensus judgment of this Office and the representatives of the bank's management and directorate that two courses of action were absolutely essential. First, the bank should form an executive recruitment committee to seek a new chief executive officer in the event that efforts to

merge the bank were not successful. Additionally, I directed the immediate designation of a chief administrative officer from the present senior management staff. Second, the bank was directed to take immediate action to seek a merger and to form an officer/director committee for that exclusive purpose. In management's opinion, based upon previous discussions, Chemical Bank was deemed the most likely merger partner and this Office concurred in this judgment.

I do not want to leave the impression that the foregoing meetings represented my only communication concerning Security National Bank. In addition to these meetings, my senior staff was in daily communication with the bank from mid-November until the bank was successfully merged. Additionally, our office was in regular contact with the Federal Reserve, the F.D.I.C. and the Anti-trust Division of the Department of Justice.

On January 19, 1975, Security National Bank accepted Chemical Bank's offer to purchase its assets and assume its liabilities. In view of the bank's serious condition, I waived shareholder approval pursuant to the provisions of 12 U.S.C. Sec. 181, which are explained below. The certification attached to this statement expands upon my testimony as to the reasons this action was taken.

On January 19, 1975, the New York State Superintendent of Banks approved Chemical's acquisition of Security's assets and liabilities. The Federal Reserve Board on that date also approved the transaction pursuant to the provisions of the Bank Merger Act, 12 U.S.C. Sec. 1828(c), and found that an emergency existed so that the acquisition could be consummated immediately. The transaction was consummated that day.

There is little doubt that Security's proximity to Franklin National Bank, as its principal competitor on Long Island, helped to aggravate an otherwise serious situation. The impact was felt more strongly than if the bank had been located elsewhere.

But I think what also must be recognized is the swiftness with which Chemical Bank reacted to this situation and was able to consummate this large, complex transaction. As a bank regulator, I am personally gratified that the private sector was able to move so quickly, without the need for governmental financial assistance to alleviate a serious problem in the financial community.

Let me turn now to the procedure used to sell the bank.

Section 181 of Title 12 of the United States Code provides inter alia that:

> "Any association may go into liquidation and be closed by the vote of its shareholders owning two-thirds of its stock. If the liquidation is to be effected in whole or in part through the sale of any of its assets to and the assumption of its deposit liabilities by another bank, the purchase and sale agreement must be approved by its shareholders owning two-thirds of its stock unless an emergency exists and the Comptroller of the Currency specifically waives such requirement for shareholder approval." (Emphasis added)

This first sentence of this statute has been in the law since the National Bank Act was passed on June 3, 1864. The second sentence was added to the section on September 8, 1959.

The report of the House Committee on Banking and Currency on the 1959 amendment indicated that if liquidation of a national bank is to be effected through the sale of any of its assets to another bank in consideration of an assumption of liabilities, approval of the purchase and sale agreement by shareholders owning two-thirds of the bank's stock must be obtained. While it was the Comptroller's policy prior to this amendment to require shareholder approval of the purchase and assumption agreement, it was the belief of Congress that there should be a statutory requirement for such approval. The report goes on to indicate that the requirement of shareholder approval could be waived if an emergency existed. (H.R. Rep. 694, 86th Congress, 1st Sess. 3, 1959).

The corresponding report of the Senate Committee on Banking and Currency explained the purpose of the new statutory requirements respecting shareholder approval as follows:

> "Section 15 would amend Revised Statutes Section 5520 (12 U.S.C. 181), relating to the liquidation of national banks, by adding a requirement that shareholders must approve a purchase and sale agreement if any part of the liquidation is to be accomplished by the sale of any of the bank's assets, but excusing the need for such a vote if in an emergency the Comptroller specifically waives it. Existing law does not require shareholder approval of any agreement the directors may make for a bulk sale of bank assets to another bank as a preliminary step to voting the selling bank into voluntary liquidation. This new provision would provide for a shareholder vote in such cases, except in emergencies."

The reason for the exception to shareholder approval in the case of emergencies does not clearly appear from the legislative history of the bill but it seems obvious that it was inserted into the law because Congress thought it desirable to waive shareholder approval under extraordinary circumstances. The language of the statute contemplates two distinct shareholder votes: One respecting voluntary liquidation as such and the other concerning approval of the purchase and sale agreement. The Comptroller's power to waive shareholder approval in appropriate circumstances extends to this latter vote requirement.

Section 181 assumes a situation in which a board of directors first negotiates a purchase and sale agreement in contemplation of a voluntary liquidation. In an emergency

situation in which the Comptroller validly waives the right of shareholder approval of the purchase and sale agreement, the validity of the contract does not depend upon shareholder approval.

The Comptroller's determination of the existence of an emergency is, however, reviewable by the courts. The standard of review applied by the courts has been characterized as the "reasonable man" rule. That is, would a reasonable man, on the basis of facts of which he was aware or should have been aware, conclude that an emergency existed. Minichello v. Saxon, 266 F. Supp. 729 (1967).

Insolvency is not the test for application of Section 181. The standard is emergency which includes something less than insolvency. The term as used in Section 181 has been held to mean a combination of circumstances less than an insolvency but sufficiently serious to require swift action to negotiate a sale. The section was designed to permit a troubled bank heading towards possible insolvency and in the midst of an emergency, to move swiftly through its directors, to sell its assets to another bank. (Minichello v. Saxon, supra).

Disclosure of Bank Customers' Records

Turning to the subject of financial privacy, I appreciate this opportunity to respond to your request for our views on H.R. 550, as well as H.R. 7483 (a re-introduced version of H.R. 2752) and H.R. 1005.

All of subject bills are designed to protect bank customers' records from being turned over to government agencies without notice to, or consent of, the customer. All contain limited exceptions designed to permit bank examiners to perform their normal functions.

Our Office fully supports the principle of the individual's right of privacy. The Treasury Department is working with other executive departments and the domestic council committee on the right of privacy to arrive at a balanced legislative proposal which would assure customers of financial institutions that their reasonable expectations of privacy in their personal financial transactions will be met, without unduly hampering legitimate law enforcement activities. The Comptroller of the Currency is actively participating with the Treasury in this study.

However, as this Committee has asked for our comments on the subject bills, we would like to express the concern of our Office that the bank examination exceptions be sufficiently broad to cover our examination and enforcement functions. While we are not prepared at this time, especially in light of the ongoing Administration review, to engage in a definitive discussion of

these bills, we recommend that Section 2(b) of H.R. 550 and Section 10 of H.R. 7483 and H.R. 1005 be amended expressly to permit this agency to report violations of law to the Department of Justice or other agencies with jurisdiction over the subject matter.

Section 5(b) of H.R. 7483 and H.R. 1005 could be interpreted as preventing a bank when notifying law enforcement authorities of violations of criminal laws from including in its notification any information derived from its records. We do not believe this was the intention of the proponents and recommend that the language be clarified. While H.R. 550 contains no provision similar to Section 5(b), it is also ambiguous as to the extent to which banks may inform law enforcement agencies of possible criminal violations.

APPENDIX TO

Statement of the Honorable James E. Smith
Comptroller of the Currency
before the
Subcommittee on Financial Institutions
Supervision, Regulation, and Insurance
of the
House Committee on Banking, Currency, and Housing
Thursday, July 17, 1975

Department of the TREASURY NEWS
COMPTROLLER OF THE CURRENCY
THE ADMINISTRATOR OF NATIONAL BANKS WASH. D.C. 20219 447-1798

For Release
July 14, 1975

Appointments of Robert Bloom as First Deputy Comptroller for Policy and H. Joe Selby as First Deputy Comptroller for Operations were announced today by Comptroller of the Currency James E. Smith, with the approval of Treasury Secretary William E. Simon.

Mr. Bloom has headed the law department of the Comptroller's office as chief counsel since 1962. Mr. Selby, currently Regional Administrator of National Banks in San Francisco, formerly served as Regional Administrator in Portland, Oregon, and as assistant chief national bank examiner in Washington. Mr. Smith said the two men will share many of the duties formerly assigned to First Deputy Justin T. Watson, whose retirement was announced last week.

Nine other members of the Comptroller's senior staff also will be assigned new and important responsibilities in connection with a re-alignment of functions currently underway. They are Robert A. Mullin and Thomas G. DeShazo, Deputy Comptrollers; Charles B. Hall, Regional Administrator of National Banks in Chicago; Kenneth W. Leaf, Chief National Bank Examiner; David N. Jones, Special Assistant for Strategic Policy Planning; Richard D. Chotard, Executive Assistant to the Comptroller; David C. Motter and W. A. Howland, Jr., Deputy Comptrollers, and C. Westbrook Murphy, Deputy Chief Counsel. Details of their new duties will be announced in the near future, Mr. Smith said.

Mr. Bloom, the First Deputy for Policy, was born in Glen Cove, New York. He was graduated from the University of Wisconsin and from Harvard Law School before joining the Comptroller's office as a staff attorney in 1961. He was named Chief Counsel the following year and has served in that capacity with four Comptrollers. He has been supervising the work of the Law Department, which handles all legal matters affecting the National Banking System. His work as Chief Counsel included drafting amendments to and interpretations of banking laws, as well as the preparing and presenting of testimony before Congressional committees. He also has served in a liaison capacity with other Federal bank regulatory agencies and State bank supervisors.

Mr. Bloom has served as chairman of the Committee on Banking Law of the Federal Bar Association and currently is vice-chairman of that committee. He has been an Adjunct Professor of Law at Georgetown University and is the recipient of the Treasury Department's Meritorious Service Award and of a Special Achievement Award from the Comptroller of the Currency. Mr. Bloom also has served on the Corporation, Business and Banking Council of the American Bar Association. He is a World War II Air Force veteran.

Mr. Selby, the First Deputy for Operations, is a native of Ganado, Texas. He was graduated from the University of Texas in 1954 with a B.A. degree in banking and finance. He was appointed as assistant national bank examiner in the Dallas Regional Office and commissioned a National Bank Examiner in 1958.

Mr. Selby served as examiner in charge of the Amarillo, Lubbock and Houston sub-regional offices from 1958 until his appointment as Supervisory National Bank Examiner for Oklahoma in 1966. The following year, he was promoted to deputy Regional Administrator in Dallas. He served as assistant Chief National Bank examiner in Washington from 1968 until he was named Regional Administrator of National Banks in Portland in 1970.

Mr. Selby was graduated from the Federal Executives Institute in Charlottesville, Virginia, in 1973. In 1974 he was named Regional Administrator in San Francisco. There he supervised the examination and regulation of national banks with total assets in excess of $103 billion. The San Francisco region, embracing California, Nevada, Hawaii and Guam, is one of the two largest in the National Banking System, with many of its larger banks involved in both foreign and domestic operations particularly subject to the stress of economic dislocations in the recent past.

A number of changes in the regional organization of the Comptroller's office will be made in connection with the reorganization of the Washington office.

Mr. Smith named John G. Hensel, currently Regional Administrator of National Banks in Richmond, to succeed Mr. Selby as Regional Administrator in San Francisco. Mr. Hensel, a native of Rice Lake, Wisconsin, is a graduate of Washington State University and of the Graduate School of Banking of the University of Wisconsin. He has been a member of the Comptroller's staff since 1957, serving as deputy Regional Administrator in Portland and assistant chief national bank examiner in Washington before going to Richmond.

Mr. Hensel will be succeeded as Regional Administrator in Richmond by Clifton A. Poole, Jr., currently examiner in charge of the Charlotte, North Carolina, sub-regional office. Mr. Poole, a native of Washington, D. C., is a graduate of Davidson College, Davidson, North Carolina. He joined the Comptroller's staff in 1956 as an assistant examiner and was commissioned a national bank examiner in 1966. Mr. Poole headed the task force of examiners involved in a current study of the Comptroller's office.

Mr. Hall will be succeeded in Chicago by Billy C. Wood, now Regional Administrator of National Banks in Atlanta. Mr. Wood, a native of Lubbock, Texas, is a graduate of Texas Tech University. He served as deputy Regional Administrator in Dallas before becoming Regional Administrator in Atlanta.

To succeed Mr. Wood in Atlanta, the Comptroller named Donald L. Tarleton, currently deputy Regioral Administrator in Portland. Mr. Tarleton, who was born in Emmett, Idaho, is a graduate of Pacific Coast Banking School. He served as an assistant examiner and was commissioned a national bank examiner before becoming deputy Regional Administrator in Portland in 1970.

Title 12—Banks and Banking

CHAPTER I—BUREAU OF THE COMPTROLLER OF THE CURRENCY, DEPARTMENT OF THE TREASURY

DISCLOSURE REQUIREMENTS

Application of Lending Limits to Standby Letters of Credit and Ineligible Acceptances

On January 22, 1974, the Comptroller of the Currency published proposed interpretive rulings which would subject standby letters of credit and ineligible acceptances to statutory limitations on loans and require footnote disclosure on balance sheets of the aggregate amount of outstanding standby letters of credit. The comments received were generally favorable to the substantive requirements imposed by the proposed rulemaking, but almost all commentators pointed out deficiencies in the definition of standby letter of credit. The most prevalent comment was that the proposed definition was ambiguous and overly broad. The definition has been revised to more precisely define the kinds of letters of credit subject to lending limits and disclosure requirements. The revised interpretive rulings and disclosure regulations are as follows:

PART 7—INTERPRETIVE RULINGS

In 12 CFR Ch. I, Part 7 is amended by revision of §§ 7.1160, 7.1550 and adding a new § 7.7361 to read as follows:

§ 7.1160 Application of lending limits to standby letters of credit.

(a) *Definition.* A "standby letter of credit" is any letter of credit, or similar arrangement however named or described, which represents an obligation to the beneficiary on the part of the issuer (1) to repay money borrowed by or advanced to or for the account of the account party or (2) to make payment on account of any indebtedness undertaken by the account party, or (3) to make payment on account of any default by the account party in the performance of an obligation.[1]

(b) *Subject to lending limits.* A standby letter of credit is subject to the limitations of section 84 and must be combined with any other nonexcepted loans to the account party by the issuing bank for the purposes of applying section 84.[2]

(c) *Exceptions.* All standby letters of credit shall be subject to the provisions of this paragraph except where:

(1) Prior to or at the time of issuance, the issuing bank is paid an amount equal to the bank's maximum liability under the standby letter of credit; or

(2) Prior to or at the time of issuance, the issuing bank has set aside sufficient funds in a segregated deposit account, clearly earmarked for that purpose, to cover the bank's maximum liability under the standby letter of credit; or

(3) The Comptroller of the Currency has found that a particular standby letter of credit or class of standby letters of credit will not expose the issuer to the similar risk of loss as would a loan to the account party.

§ 7.1550 Exception 5: Bankers' Acceptances.

(a) Law—12 U.S.C. 84(5)

[Such limitation of 10 per centum shall be subject to the following exceptions:]

(5) Obligations in the form of bankers' acceptances of other banks of the kind described in (12 U.S.C. 372 and 373) shall not be subject under this section to any limitation based upon such capital and surplus.

(b) Acceptances of other banks: Exception 5 permits the purchase by a national bank without limitation of bankers' acceptances made by other banks, provided that such acceptances are of the kinds described in section 372 and 373 (eligible acceptances). Other kinds of acceptances (ineligible acceptances) made by other banks are included within the purchasing bank's lending limit to each acceptor bank.

(c) Own acceptances. (1) *Eligible.* The limits under which a national bank may itself accept drafts eligible for rediscount are contained in sections 372 and 373. Said limits are distinct from the section 84 limit. Thus a bank may accept eligible drafts for a customer up to the amount permitted by sections 372 and 373 at the same time that customer is indebted to the bank in other ways up to his section 84 limit.

(2) *Ineligible.* An "ineligible" acceptance is a time draft accepted by a bank which does not meet the requirements for discount with a Federal Reserve bank. A national bank may accept ineligible paper on behalf of a customer only within the limits of section 84. All nonexcepted indebtedness of the customer to the accepting bank must be combined with his obligations in regard to ineligible paper and the total may not exceed the section 84 lending limit.

(3) *Discount of own acceptance.* During any period within which a bank holds its own acceptance, eligible or ineligible, having given value therefor, the amount thereof is included against the section 84 limit of the customer for whom the acceptance was made.

§ 7.7361 Standby letters of credit or ineligible acceptance on behalf of affiliate.

Standby letters of credit as defined in § 7.1160 of this part and ineligible acceptances constitute extensions of credit within the meaning of 12 U.S.C. 371c, when issued on behalf of an affiliate.

PART 11—SECURITIES ACT DISCLOSURE RULES

In 12 CFR Chapter I, Part 11 is amended by adding to § 11.7(c)(9), *General notes to balance sheets*, a new subparagraph (viii) as follows:

§ 11.7 Form and content of financial statements.

(c) • • •

(9) • • •

• • • • • •

(viii) *Standby letters of credit.* A "standby letter of credit" is any letter of credit, or similar arrangement however named or described, which represents an obligation to the beneficiary on the part of the issuer (a) to repay money borrowed by or advanced to or for the account of the account party, or (b) to make payment on account of any indebtedness undertaken by the account party, or (c) to make payment on account of any default by the account party in the performance of an obligation. Do not include standby letter of credit for which the issuing bank has either been paid an amount equal to its maximum liability thereunder or has set aside sufficient funds in a segregated account, clearly earmarked for that purpose, to cover the bank's maximum liability.

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PART 18—FORM AND CONTENT OF FINANCIAL STATEMENTS

In 12 CFR Ch. I, Part 18 is amended by revising § 18.2 and by adding a new paragraph (f) to § 18.8 to read as follows:

§ 18.2 Definitions of terms.

A "standby letter of credit" is any letter of credit, or similar arrangement however named or described, which represents an obligation to the beneficiary on the part of the issuer (a) to repay money borrowed by or advanced to or for the account of the account party, or (b) to make payment on account of any indebtedness undertaken by the account party, or (c) to make payment on account of any default by the account party in the performance of an obligation. Do

[1] As defined in this subsection (a), the term "standby letter of credit" does not include commercial letters of credit and similar instruments where the issuing bank expects the beneficiary to draw upon the issuer, which do not "guaranty" payment of a money obligation and which do not provide for payment in the event of default by the account party.

[2] Where the standby letter of credit is subject to a nonrecourse participation agreement with another bank or banks, this paragraph shall apply to the issuer and each participant in the same manner as in the case of a participated loan.

not include standby letters of credit for which the issuing bank has either been paid an amount equal to its maximum liability thereunder or has set aside sufficient funds in a segregated deposit account, clearly earmarked for that purpose, to cover the bank's maximum liability.

§ 18.8 Rules of general application.

* * * * *

(f) Furnish in a footnote to Item 19 of the balance sheet, the amount of outstanding standby letters of credit.

The above revisions become effective on September 16, 1974, standby letters of credit and ineligible acceptances issued or renewed after said date are subject to revised §§ 7.1160, 7.1550 and new 7.7361; all financial statements subject to Parts 11 and 18 issued after said date shall contain the footnotes required by new §§ 11.7(c)(9)(viii) and § 18.8(f).

Dated: August 9, 1974.

[SEAL] JAMES E. SMITH,
Comptroller of the Currency.

[FR Doc.74-18553 Filed 8-12-74;8:45 am]

PART 23--STATEMENTS OF BUSINESS INTEREST OF DIRECTORS AND PRINCIPAL OFFICERS OF NATIONAL BANKS

Sec.

23.1 Authority and scope.

23.2 Definitions.

23.3 Filing of statement.

23.4 Location and retention of statements.

23.5 Reservation to Comptroller.

Authority: 12 U.S.C. 161, 481, 1818, 1820

23.1 Authority and scope.

(a) This part is issued by the Comptroller of the Currency pursuant to sections 161, 481, 1818, and 1820 of Title 12 of the United States Code. This part requires the filing of a Statement of Interest, Form CC-9030-29, by directors and principal officers of national banks. An initial statement must be filed by July 1, 1975, or within 30 days after attaining the position of director or principal officer of a national bank, whichever is later.

(b) Each completed Form CC-9030-29 is to be kept at the main office of the designated bank for review by national bank examiners and by the following persons associated with the designated bank: directors; senior loan officers; and auditors or attorneys whose responsibilities require access to such statements.

23.2 Definitions.

For purposes of this part:

(a) The term "agreement" means a contract, lease, or other agreement or understanding -- other than an extension of credit or deposit -- pursuant to which the designated bank receives or provides any tangible or intangible goods, property, or service.

(b) The term "business enterprise" means a corporation, association, business trust, partnership, joint venture, pool, syndicate, sole proprietorship or any other form of business not specifically listed herein, whether or not such enterprise has engaged in transactions with the designated bank. The term "business enterprise" also includes any personal or family trust and any charitable, social, fraternal, civic, governmental or recreational association, trust, club, agency or other organization if, and only if, such enterprise has engaged in any transaction with the designated bank, other than making a deposit or soliciting or receiving contributions, during the last year. The term "business enterprise" excludes (i) the designated bank; (ii) a corporation, partnership, or joint venture which is 50 percent or more owned by the designated bank; (iii) a holding company whose control of the designated bank is registered with or approved by the Board of Governors of the Federal Reserve System, pursuant to Sections 3 or 5 of the Bank Holding Company Act, 12 U.S.C. 1842 or 1844, or any of such holding company's subsidiaries the control of which has been registered with or approved by the Board of Governors of the Federal Reserve System pursuant to

Section 3, 4 or 5 of the Bank Holding Company Act, 12 U.S.C. 1842, 1843 or 1844; and (iv) a Federal Reserve Bank.

(c) The term "deposit" means an unpaid balance of money or its equivalent received or held by the designated bank in the usual course of business and for which it has given or is obliged to give credit, either conditionally or unconditionally, to a commercial, checking, or savings account, or which is evidenced by a certificate of deposit.

(d) The term "designated bank" means the particular national bank of which a person required by this part to file a Statement of Interest is a director or principal officer.

(e) The term "extension of credit" means the making of a loan or the extending of credit in any manner whatsoever by the designated bank and shall include (without limitation):

(1) A loan

(2) An advance by means of an overdraft, cash item or otherwise.

(3) The acquisition by discount, purchase, exchange or otherwise of a note, draft, bill of exchange or other evidence of indebtedness.

(4) An acceptance.

(5) A letter of credit.

(6) A purchase of securities, accounts receivable or other chose in action under a repurchase agreement.

(f) The term "insignificant transaction" means an extension of credit or agreement which is of such insignificance to the designated bank that the senior management of the designated bank should not be

expected in the normal course of business to be aware of the transaction. For the purposes of this Part, the following transactions shall be deemed to be prima facie insignificant:

(1) If the designated bank had as of the preceding quarterly report of condition total assets of less than $50 million, any transaction which involves an amount not exceeding $10,000.

(2) If the designated bank had as of the preceding quarterly report of condition total assets equal to or exceeding $50 million and less than $300 million, any transaction which involves an amount not exceeding $25,000.

(3) If the designated bank had as of the preceding quarterly report of condition total assets equal to or exceeding $300 million and less than $1 billion, any transaction which involves an amount not exceeding $50,000.

(4) If the designated bank had as of the preceding quarterly report of condition total assets equal to or exceeding $1 billion, any transaction which involves an amount not exceeding $100,000.

(g) The term "interest" with regard to a business enterprise means:

(1) Ownership, whether legal, equitable or otherwise, of stock or other forms of legal or equitable participation in the enterprise by the reporting person and/or his spouse, or minor children which, when aggregated, equals or exceeds either 10 percent of the enterprise's total outstanding indicia of ownership, or, in the case of stock, 10 percent of the total outstanding shares of any class of stock;

(2) Indebtedness (aggregated among the reporting person and his spouse and minor children):

(i) equal to or exceeding $100,000 owed to the enterprise; or

(ii) equal to or exceeding $100,000 or five percent of the enterprise's outstanding debt, whichever is larger, owed from the enterprise;

(3) The holding by the reporting person or his spouse or minor child of a position in the enterprise; or

(4) The possession, directly or indirectly, by the reporting person of the power to direct or cause the direction of the management or policies of the enterprise, whether through the ownership of securities, by contract, by intercompany relationships, or otherwise.

(h) The term "material change" means:

(1) The acquisition or termination of an interest in a business enterprise.

(2) The creation or termination, or significant change in the terms or conditions of any reportable transaction.

(i) The term "position" with regard to a business enterprise means an officer, director, trustee or partner. The term also includes an employee, beneficiary, participant, or associate with managerial or policy-making responsibilities, or any similar office regardless of title.

(j) The term "principal officer" with regard to a national bank means a person who participates in major policy-making functions of the bank, and usually includes the chairman of the board of directors,

president, cashier, treasurer, secretary, controller, and vice president, or anyone exercising the functions normally associated with those positions.

(k) (1) The term "reportable transaction" means an agreement or extension of credit, which is not an insignificant transaction, made to or for the account or benefit of, or with direct or contingent recourse to the reporting person, his or her spouse, minor child or any business enterprise in which the reporting person, his or her spouse or minor child have an interest, which does not appear on the bank's books as having been so made.

(2) The following examples of reportable transactions are for illustrative purposes only and are not meant to be exclusive. In all examples "X" refers to a person or business enterprise other than the reporting persor, his or her spouse, minor child or business interest of any of them.

(i) An extension of credit to X, the proceeds of which are turned over to, reloaned to, or otherwise inure to the benefit of the reporting person, his or her spouse, minor child or business interest of any of them.

(ii) An extension of credit to X for the purpose of financing an enterprise in which the reporting person, his or her spouse, minor child or business interest of any of them, has an interest.

(iii) An extension of credit to X concerning which the reporting person, his or her spouse, minor child or a business interest of any of them has an agreement with X to hold X harmless against risk of loss.

(iv) The purchase of real property by the designated bank from X, subject to a mortgage held by the reporting person, his or her spouse, minor child or a business interest of any of them.

(3) The following are examples of transactions which do not have to be reported:

(i) A direct extension of credit to the reporting person, his or her spouse, minor child or business enterprise in which any of them have an interest.

(ii) An extension of credit to X on which the reporting person, his or her spouse, minor child or business enterprise in which any of them have an interest, appears on the designated bank's records as a guarantor.

(1) The term "reporting person" means a director or principal officer of a national bank who is required by this part to file a Form CC-9030-29.

23.3 Filing of statement.

Every director or principal officer of a national bank is required to maintain on file with the bank as prescribed in this Regulation one or more Forms CC-9030-29. The director or principal officer shall complete and file Forms CC-9030-29 with the designated bank within 30 days after becoming a director or principal officer, or by July 1,

1975, whichever is later. Thereafter, the reporting person shall complete and file with the designated bank a new Form CC-9030-29 within 30 days after the occurrence of any material change. The reporting person shall include on the Forms, in accordance with applicable instructions, the required information concerning any business enterprise in which the reporting person, his or her spouse or minor child have an interest and any reportable transaction. If the reporting person, his or her spouse or minor child have no interest in any business enterprise, the reporting person shall complete and file a Form CC-9030-29 so stating.

23.4 Location, review and retention of statements.

(a) All Forms CC-9030-29 shall be maintained at the head office of the bank during the tenure of the reporting person as an official of the bank. Forms CC-9030-29 which have been superseded by a new or corrected Form shall be retained together with the new Form for a period of two years.

(b) Nothing contained in this regulation shall be construed: (i) To prevent a national bank from adopting reasonable procedures governing the manner in which persons associated with the bank and entitled under this regulation to review Forms CC-9030-29 shall obtain access to such Forms; or (ii) to require a national bank to make a Form CC-9030-29 available for review other than as required by this regulation.

(c) If any director or principal officer of a designated national bank ceases to serve in that capacity, the bank nevertheless shall retain for a period of two years or until all extensions of credit

listed thereon have been paid, whichever is later, any Form CC-9030-29 completed and filed by such officer or director before he ceased to serve in that capacity.

23.5 Reservation to Comptroller.

The Comptroller may, in his sole discretion:

(a) Require under relevant statutes such additional reports or information as he deems necessary.

(b) Give prior written approval to the request of a national bank to modify the applicability of this part to that bank because of that bank's particular circumstances.

Effective date: This part becomes effective on May 1, 1975.

OFFICE OF THE COMPTROLLER OF THE CURRENCY

TREASURY DEPARTMENT

In the matter of Security National Bank Hempstead, New York	)))	CERTIFICATION

I, James E. Smith, Comptroller of the Currency, do hereby certify that:

There exists an emergency at Security National Bank, Hempstead, New York, ("Security") whereby pursuant to the provisions of Title 12 U.S.C. 181 shareholder approval, by the shareholders of Security, is specifically waived for Security to sell its assets to and have its deposits liabilities assumed by Chemical Bank, New York, New York.

This certification is made upon the basis of my personal knowledge and the official records of the Office of the Comptroller of the Currency.

This certification is further made to support my conclusion that in order to prevent the probable failure of Security immediate action is required by the Federal Reserve Board pursuant to the provision of 12 U.S.C. 1828(c)(6).

Security was chartered by the Comptroller's Office in 1903 and presently has approximately 10,500 shareholders. As of December 6, 1974, Security had total resources of $1.7 billion, deposits of $1.3 billion and loans of $1.2 billion. Security operates through its main office and 97 branches, most of which are located on Long Island, New York.

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A regular examination of Security by the Comptroller, pursuant to 12 U.S.C. 481, commenced on June 24, 1974, and concluded on September 25, 1974. Another regular examination of Security commenced on December 6, 1974, and concluded on January 17, 1975. These examinations disclosed that Security has serious financial problems. Based upon available information I have concluded that external forces and public confidence have adversely affected the operations and condition of Security to the point that an emergency exists. The reasons for this conclusion are hereinafter set forth.

During 1974 Security was a continual and heavy borrower of federal funds from other banks. Much of this borrowing was attributable to the approximately $236 million in deposit run-off between mid-January 1974 and mid-January 1975. These borrowings ranged from an average monthly low during January 1974 of $164 million to an average monthly high during August 1974 of approximately $330 million.

During the summer of 1974 certain important financial institutions and brokers cancelled sales of federal funds to Security. Two institutions which had supplied an aggregate of $50 million decided to forego future loans to Security. To further aggravate the problem, another institution which sold Security upwards of $30 million on a daily basis, dropped its sales to $20 million on a substantially less frequent basis. These three financial institutions were the single largest sellers of funds to Security, at times accounting for 40 to 50 percent of the bank's needs. In addition, during August, an important foreign source of funds accounting for $40 million daily to Security also withheld sales.

The overall effect of these cancellations caused Security to seek assistance from the larger money market banks, which at this time Security was able to obtain, thus preserving for the time being access to the federal funds market. However, as of January 13, 1975, the federal funds market was virtually closed to Security.

Security has suffered a severe and continuing deterioration in its loan portfolio. Total loans classified at the conclusion of the June 24, 1974, examination were $171.9 million which was 110 percent of gross capital funds. At the conclusion of the December 6, 1974, examination loans subject to classification had increased to $233.5 million which was 156 percent of gross capital funds. Loans classified as losses increased almost 100 percent from $12.2 million to $24.2 million between examinations. Loans classified as of doubtful collectibility increased by almost $15 million from $52.9 million to $67.6 million between examinations. At the conclusion of the December examination, the bank's adjusted capital funds were $91 million. They included $6 million in debentures and $18 million in reserves, less estimated losses and 50 percent of loans classified as doubtful. This $91 million in adjusted capital structure appears inadequate to absorb the potential losses in the $298.9 million in other criticized loans. Loans in a nonaccrual status are $135 million, and this figure represents a $41 million increase between examinations. Nonaccrual loans are delinquent

loans upon which the ultimate payment of interest is not anticipated by the bank. The quality of the loan portfolio which evidenced substantial deterioration between examinations will, in my judgment, sustain substantial future losses. Numerous loans classified as of doubtful collectibility are in extreme jeopardy.

Security's position has continued to deteriorate since January 1, 1975. As of January 16, 1975, Security had total deposits of $1,263 million. The banks was the target of adverse newspaper publicity on January 13, 1975, when a Wall Street Journal newspaper article publicized some of the problems Security was encountering. In the week prior to this article Security was not in debt to the Federal Reserve Bank of New York for four consecutive days. On the date the article appeared Security had to borrow $165 million from the Federal Reserve Bank and this amount increased daily to $215 million as of January 17, 1975. These borrowings at the Federal Reserve Bank off-set the loss of available funds in the federal funds market. The average daily borrowing in the federal funds market was $169 million prior to publication of the Wall Street Journal article. After the article the average daily borrowing was $25 million, including $5 million from Chemical Bank. During the four days following this article, Security also suffered a run-off of $64 million in deposits. Because of this article and other publicity the condition of Security has been further exacerbated. The $215 million borrowed from the Federal Reserve represents more than twice the average monthly borrowings from the Federal Reserve during 1974.

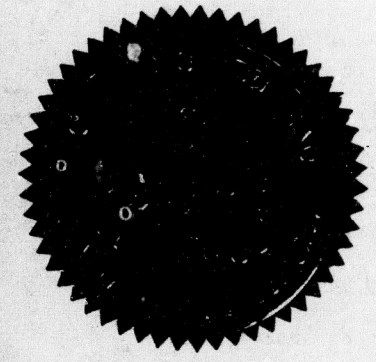
It is extremely unlikely that Security legally will be able to declare its March dividend. Title 12 U.S.C. 56 provides inter alia: "If losses have at any time been sustained by any association, equal to or exceeding its undivided profits. . . no dividend shall be made, and no dividend shall ever be made by any association while it continues its banking operations, to an amount greater than its net profits then on hand deducting therefrom its losses and bad debts. All debts due to any association on which interest is past due and unpaid for a period of six months, unless the same are well secured, and in process of collection, shall be considered bad debts within the meaning of this section." Security presently has $85 million in loans upon which interest is at least six months past due and owing which amount is projected to be substantially greater than its undivided profits. The attendant publicity to an announcement by Security that it must forego its quarterly dividend together with the other problems heretofore discussed can only aggravate an already precarious position.

On January 18 , 1975, an offer was made to Security contemplating the sale of its assets and the assumption of certain of its liabilities by Chemical Bank, New York, New York. Title 12 U.S.C. 181, was designed to permit a troubled bank such as Security, heading toward a possible insolvency and in the midst of an emergency, to move swiftly, through its board of directors, to sell its assets to another bank which will also assume its deposit liabilities. The requirement of shareholder approval of such an offer or agreement may be specifically waived by the Comptroller if an emergency is found to exist. The Comptroller is not

required to wait until a bank is insolvent but may make such a determination when the facts demonstrate a combination of circumstances less than an insolvency but sufficiently serious to require swift action to consummate a sale.

Accordingly, and in relation to the above-mentioned offer for the sale of assets and assumption of liabilities, and based upon my examination of the affairs of Security National Bank including the facts recited in this Certification, I hereby declare that an emergency exists and specifically waive the requirement for shareholder approval as provided by Title 12 U.S.C. 181.

Furthermore, for the reasons of the presently declared emergency, I believe that immediate action by the Federal Reserve Board is necessary to prevent the probable failure of Security and urge that the transaction be approved and consummated immediately.



IN TESTIMONY WHEREOF, I have hereunto subscribed my name and caused the Seal of Office of the Comptroller of the Currency to be affixed to these presents at the Offices of the Comptroller of the Currency, in the City of Washington and District of Columbia this 18th day of January 1975.

James E. Smith
Comptroller of the Currency

Mr. ST GERMAIN. The subcommittee will adjourn to reconvene at 10 a.m. Monday.

[Whereupon, at 11:35 a.m., the subcommittee was adjourned, to reconvene at 10 a.m., Monday, July 21, 1975.]

BANK FAILURES

REGULATORY REFORM

FINANCIAL PRIVACY

MONDAY, JULY 21, 1975

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
SUPERVISION, REGULATION AND INSURANCE
OF THE COMMITTEE ON BANKING, CURRENCY AND HOUSING,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:05 a.m., in room 2128, Rayburn House Office Building, Hon. Fernand J. St Germain [chairman of the subcommittee] presiding.

Present: Representatives St Germain, Fauntroy, Boggs, Patterson, Rousselot, Johnson, and Gradison.

Mr. ST GERMAIN. The subcommittee will come to order. We want to welcome Chairman Wille, of the FDIC, and Hon. Stephen Gardner, Deputy Secretary of the Treasury. At this point, if there is no objection, I will place into the record a copy of the subcommittee's letters of invitation to this morning's witnesses as well as my opening statement.

[The material referred to follows:]

U.S. HOUSE OF REPRESENTATIVES,
Washington, D.C., June 30, 1975.

Hon. STEPHEN S. GARDNER,
Deputy Secretary of the Treasury,
Washington, D.C.

DEAR MR. GARDNER: As you know, the subcommittee commenced hearings June 26th on H.R. 8024 and related bills, copies of which are enclosed. My opening statement, a copy of which is enclosed, underscores the importance of this bill and the significance of the issues raised as an integral part of the FINE Study.

The position of the Treasury Department is required on Title I and Title II of the bill. Your observations on Title III will, of course, be welcome. As we review the question of the relationship between thrift institutions and banks, it is important to observe that increasingly a significant segment of our population in our cities is unable to obtain either mortgage financing or rehabilitation loans. Title III seeks to establish a national information network to assist government, financial institutions and private individuals in our collective efforts to restore our cities to the once-proud position they occupied in our nation.

During our hearings the subcommittee will also be receiving testimony on several measures and is also interested in the Department's position on H.R. 2752, introduced by Mr. Stark, and subsequently reintroduced with thirty-six

cosponsors and H.R. 1005, introduced by Mr. Rousselot, our ranking minority member, copies of which are attached. Chairman Reuss requested a report from the Department on H.R. 550 introduced by Mr. Koch, a copy of which is attached, on February 10, 1975, and I have been informed by the full committee that their records indicate that no reply has been received. In view of the subcommittee's interest in the issue of bank secrecy, we would also appreciate the Department's position on H.R. 550 at this time. This subject is extremely important since it involves the constitutionally-guaranteed right to privacy. In light of the recent court decisions handed down by both the Supreme Court of the State of California (Burrows v. Superior Court) and the U.S. Supreme Court (U.S., et al., v. Bisceglia and CBA v. Shultz), the subcommittee recognizes the need for action in this area. It is our hope to proceed with the mark-up on a bill dealing with this matter upon the return of Congress from the August recess.

Accordingly, your appearance is requested before the subcommittee in Room 2128, Rayburn House Office Building at 10:00 a.m. on July 21, 1975.

In accordance with the Rules of the Committee, to permit distribution to subcommittee members, please submit 80 copies of your prepared testimony to the subcommittee office, Room B303, Rayburn House Office Building, by noon Thursday, July 17.

Sincerely,

FERNAND J. ST GERMAIN,
Chairman.

U.S. HOUSE OF REPRESENTATIVES,
Washington, D.C., June 27, 1975.

Hon. FRANK R. WILLE,
Chairman, Federal Deposit Insurance Corporation,
Washington, D.C.

DEAR MR. CHAIRMAN: As per our previous discussion and the continuing discussion between our respective staff members, I request your appearance before the subcommittee on July 21, 1975, at 10:00 a.m. in Room 2128, Rayburn House Office Building. At this time the subcommittee will receive your proposals for bank regulatory reform. In addition, we would appreciate hearing your views on bank structural reform since they will be of assistance in our continuing deliberation in connection with the FINE Study. We anticipate the need for a full day to allow for adequate consideration of your views on these important areas.

As you know, on June 18, 1975, I introduced H.R. 8024, a copy of which is attached. On June 26, the Subcommittee on Financial Institutions commenced hearings on this bill, and I am enclosing a copy of my opening statement delivered on that day. Inasmuch as each of the regulatory agencies will be appearing before us on bank reform matters from July 15 through July 21, we will accept a written statement on the Corporation's views on the bill in lieu of a personal appearance. We do not plan to mark-up H.R. 8024 until the conclusion of our bank regulatory hearings.

During the hearings on July 21 we will first concentrate on the developments which resulted in the Franklin National Bank being placed into receivership and those events which occurred subsequent to that process. The subcommittee is interested in the role of the Corporation, along with those of the other bank regulatory agencies in this unfortunate incident and its aftermath. We would like you to address yourself to the procedures, the cost estimates and the legal issues which involved the Corporation at each stage of this process. In addition, we would also be interested in an updating of the receivership of the U.S. National Bank of San Diego, which would include a discussion of future cost estimates, the legal issues encountered and any unforeseen problems that have arisen. We also anticipate looking into the background of the sale of the Security National Bank to the Chemical Bank. Although Mr. Smith will be discussing this matter when he appears before us, we would also be interested in knowing whether the Corporation was consulted or at all involved at any time prior to the sale of the bank.

The case of the Franklin National Bank along with those of the United States National Bank of San Diego and the Security National Bank have raised serious problems with respect to the adequacy of the present system of bank regulation and the coordination of roles of the different regulatory agencies with overlapping jurisdiction. The subcommittee is interested in recommendations, both legislative and rulemaking, that the corporation is considering in this area. As you

are aware, we are in the process of conducting the FINE Study which encompasses the broad field of future bank reform and the restructuring of the roles and organization of the regulatory agencies. This study will explore both the feasibility of both immediate and long-term modifications of the present system. We would also appreciate your addressing your remarks to both immediate and long-term reforms. I have found your experience as both a state and Federal bank regulator to be invaluable and would like to have the opportunity to gain from your highly-developed expertise. I would appreciate hearing your views both on behalf of the Corporation and as an individual in the area.

Finally we are also interested in the Corporation's position on H.R. 2752, introduced by Mr. Stark, and subsequently reintroduced with thirty-six cosponsors and H.R. 1005, introduced by Mr. Rousselot, our ranking minority member, copies of which are attached. We requested the Corporation's views on the predecessor bills in August 1973, and, as yet, have not received a response to this inquiry. Also, Mr. Reuss requested a report from the Corporation on H.R. 550, introduced by Mr. Koch, a copy of which is enclosed, on February 10, 1975, and I have been informed by the full committee that their records indicate that no such report has been received from the Corporation. In view of the subcommittee's interest in the issue of bank secrecy, we would also appreciate the Corporation's position on H.R. 550 at this time. This subject is extremely important since it involves the constitutionally-guaranteed right to privacy. It is important to receive the bank regulatory agencies' views on this legislation because of their familiarity with the internal procedures used in this area and the effect such legislation will have on the roles of the regulatory agencies themselves. In light of the recent court decisions handed down by both the Supreme Court of the State of California (Burrows v. Superior Court) and the U.S. Supreme Court (U.S. et al., v. Bisceglia, and CBA v. Shultz), the subcommittee recognizes the need for action in this area. It is our hope to proceed with the mark-up on a bill dealing with this matter upon the return of Congress from the August recess.

In accordance with the Rules of the Committee, to permit distribution to subcommittee members, please submit 80 copies of your prepared testimony to the subcommittee office, Room B303, Rayburn House Office Building, by noon Friday, July 18.

Sincerely,

FERNAND J. ST GERMAIN,
Chairman.

OPENING STATEMENT OF CHAIRMAN FERNAND J. ST GERMAIN

This morning the Subcommittee welcomes the Honorable Frank R. Wille, Chairman of the Federal Deposit Insurance Corporation and the Honorable Stephen S. Gardner, Deputy Secretary of the Treasury.

At this point, if there is no objection, I wish to place into the record a copy of the Subcommittee's letters of invitation to this morning's witnesses.

As I have done on the preceding days of our hearings on H.R. 8024, I wish to clarify several aspects of title II, the 90-days EFTS moratorium which, as you are probably aware, has led to a favorable response from the other regulatory agencies. In fact, the Federal Home Loan Bank Board, during our hearings, modified its written position and agreed to a limited moratorium.

First, the use of the word "control" in title II was not intended to indicate that the Commission would take over from the regulatory agencies the authority to approve EFTS experiments or to second guess such approvals. At the end of the 90 days, the Commission will merely advise the Committee of its plans for the evaluation of such experiments insuring full and adequate consideration of the public policy questions throughout. Due to the apparent misunderstanding involving the use of the word "control" in the bill, when the Subcommittee received testimony from the Federal Home Loan Bank Board, I agreed to delete the language making reference to "control."

Second, title II in no way affects the continuation or implementation of EFT systems which have already been established. It simply gives the Commission time to get organized, review what has taken place to date insofar as experimentation is concerned, study the procedures utilized by the regulatory agencies, and to advise the respective committees of jurisdiction at the end of a 90-day period of its plans for the continuing review and evaluation of on-going experiments in furtherance of the Commission's mandated objectives.

Each regulatory agency, during the past two and a half years this Subcommittee has been studying EFTS questions, on more than one occasion has expressed its support for the Commission. I must state that I have been encouraged by the constructive suggestions received to date from each of the regulatory agencies on title II. Likewise, I am hopeful that each regulatory agency will furnish evidence of their support by working together within the Commission framework to insure public understanding and acceptance of EFTS developments.

Mr. ST GERMAIN. I am quite certain that both of you are aware of the opening statement I made in the last few hearings, with respect to title II of the legislation, and therefore, I shall place it into the record, in its entirety, without objection. I state that it is my hope, in view of the fact that the regulatory agencies have all expressed the fact that, in their opinion, they felt the Commission was very helpful and could be very instrumental in the problem areas of EFTS, that we can look to Treasury and FDIC, as we hope to be able to do with other agencies, for constructive suggestions with respect to title II.

I have read your statements. However, we intend to pursue the matter of EFTS. When the legislation was introduced, no one contended that it was perfect in any way, shape, manner, or fashion. So we are grateful to the witnesses who to date have made constructive suggestions and we are looking forward to more of them, from both the FDIC and Treasury.

I note that there has been a quorum call and I am going to run over and answer that quorum very quickly. I shall then immediately return, and we will proceed with the taking of your testimony.

The subcommittee will be in recess for a period of about 10 to 12 minutes, depending on how avaliable the elevators are.

[After recess.]

Mr. ST GERMAIN. The subcommittee will come to order.

Secretary Gardner, we will place your entire statement in the record, as written, and you may comment on it and highlight it if you wish.

STATEMENT OF STEPHEN S. GARDNER, DEPUTY SECRETARY OF THE TREASURY

Mr. GARDNER. I would be glad to, Mr. Chairman.

As you know, I am here to testify on the various titles of House bill 8024, which would extend the authority of regulatory agencies to limit time and savings deposit rates for banks, and savings and loan associations. I have said a good deal in my testimony about the problems that we have in eventually getting full financial reform, which I know your subcommittee is interested in. I do feel that the extension of regulation Q authority until 18 months from now is too long a period, as I have stated in my testimony. I think that if the subcommittee would adopt the idea of extending the Q ceilings and their rates for a 6-month period until June 30, 1976, it would be a clear signal to the financial community and the regulatory agencies that reform is imminent. I think it would be therapeutic, because we are indeed discussing and looking at a very large number of financial institution reform proposals, including, of course, those which will evolve from the FINE study. We hope to assist and participate with you in those deliberations.

On the matter of title II, I think, Mr. Chairman, you are as

thoroughly familiar with the EFTS Commission problems as I am. I wholeheartedly support the provision of the bill which would extend the life of the EFTS Commission. As you know, the subcommittee has been justifiably concerned by the delay in appointing the Commission. I am confident that there will be a commission in the very near future.

As stated in my testimony, I also want to make clear that some of the problems involved in appointing the Commission have been more mechanical than lack of resolve on the part of the administration. The legislation is drawn very carefully. It requires Senate confirmation of the chairman. It requires that the chairman not have any conflicts of interest by affiliation with the various types of financial institutions, or similar organizations. The plain fact is that several good candidates who were interested in performing this public service just could not reach a decision to eliminate their conflicting private arrangements.

I think that the chairman is going to be appointed soon, and the rest of the Commission will be nominated very quickly thereafter. I hope the subcommittee does understand that there has been a great deal of work done in the administration in trying to attract people of the caliber, stature, and freedom to act independently as public members of this Commission. As you know, we support the extension of the Commission's life contained in section 201.

We do have some reservations about the other aspects of the title. You have already stated this morning and in your opening statements at other hearings that section 202(a) should be modified to eliminate or change the word control. We support that and believe it is necessary because of the overlap with regulatory agencies, who, indeed, have a full span of control.

I want to point out, Mr. Chairman, that electronic funds transfer is not a new concept. It is certainly the result of an ongoing evolution in recordkeeping, statistics, science, and education in America. We are applying new techniques, new technology, to automate all of the extensions of man's knowledge through written and numerical systems, and it is very logical that the financial system, which has evolved over hundreds of years, would immediately begin to use these great scientific aids to codify records, perform tasks more simply, and to handle transactions.

It is very logical that this technology would evolve into the use of off-premises terminals and the like, and the pursuit of ways to free man from the tyranny of paperwork and from the tyranny of delay.

As I have pointed out in my testimony, oil companies do an enormous volume of business, through their credit card systems. The receipts from credit card billings are rarely seen by the company because they are mailed to a post office box at a financial institution where they are mechanically processed. Similarly, advanced electronic techniques are used by many companies to prepare accounts, to automate their billing and collection systems. I do not think we should consider Electronic Funds Transfer Systems to be a great threat to the existing financial structure. Clearly, the use of electronic data processing in financial transactions is the normal outgrowth of a great evolution that is continuing in all of man's recordkeeping and areas of knowledge.

Title II also directs the Commission to prepare a report within 90 days containing recommendations for further legislation, a proposal to monitor all EFTS experimentation and methods for evaluating such experimentation. We feel the Commission should evaluate significant experimentation, but do not think a competent job can be accomplished within a period of only 3 months. In addition, we feel it is too early for the Commission to recommend strict limits on experimentation.

In view of this, we would support a recommendation that the Commission be asked to present a report within a period of 6 months. Included in the report would be a review of the status of experimentation, a discussion of the implications, and any recommendations for congressional action.

Title II also directs a moratorium on EFTS experimentation during this 90-day period. Mr. Chairman, the pace of this experimentation is very moderate at the present and I do not think it will significantly increase during the time period needed for the Commission to prepare its preliminary report. I think a moratorium would be neither relevant or practical and would unduly penalize those institutions which have already planned EFTS experimentation. There is a certain illogic, I think, in directing the Commission to study EFTS experimentation and simultaneously prohibiting the experimentation itself.

Title III contains the proposed Mortgage Disclosure Act, which requires depository institutions to compile and disclose public information on commercial and residential real estate loans, and savings, by census tract. I know there has been a great deal of controversy about this, and arguments have been set forth opposing this legislation on the basis of excessive cost and because of the uncertain value of statistics. I share some of these concerns, but I believe the question raised by the legislation is much more far reaching and fundamental.

It involves a basic assessment as to where the responsibility lies, as we all seek to maintain and restore our urban neighborhoods. The deterioration in the housing stock in our central cities is a major concern. It is true that one of the keys in resolving this problem lies in the ability of property owners to obtain financing to buy, repair, improve, or sell such housing. However, the responsibility to help maintain and restore our urban neighborhoods does not lie solely with the Nation's private financial institutions. They are only one part of the equation.

Equally important is the involvement of local city governments, and of the neighborhoods themselves. These three groups make up an important triumvirate, if the dilemma of urban decline is to be met.

The fact is that the financial institutions must also be concerned about their depositors, and if they are asked to act alone in a neglected neighborhood, they could endanger depositors' assets, and the assistance programs could also be very unsuccessful. There must be commitments from the neighborhoods themselves, and the cities, or towns which must be willing to join with appropriate services.

I want to make one other comment on title III, Mr. Chairman. In attempting to compare the source of savings and the granting of residential real estate loans on a geographic basis, there is a clear implication that a parity between the two results would be desirable,

and that deposits should be invested in the community or origin. I agree that urban banks should invest in the city, but one of the major strengths of our economy is a very large and flexible capital market, where funds can and do flow from capital-rich to capital-poor areas, and specifically from areas where housing funds are in surplus to those where they are deficient. I think we should avoid any suggestion that this reverse flow of funds back to the city should not be encouraged.

The key is to make sure that our capital markets are large enough and flexible enough to meet our needs. I do not mean to suggest, by any means, that financial institutions, or for that matter, private corporations, governmental units, community groups, or individuals should neglect the problems which confront us all. We all bear some responsibility for their creation, and it is absolutely vital in this country that we restore our neighborhoods and cities, which have been such a great strength in our economy.

Finally, I would like to make one comment related to the various bills you are considering, concerning the confidentiality of bank records. We are keenly aware of the interest of Congress and the administration in establishing a set of rules governing the confidentiality of financial records and access to such records by Federal and State law enforcement agencies. Treasury is working with other executive departments on the Domestic Council to arrive at a balanced legislative proposal, which would assure customers of financial institutions that their reasonable expectations of privacy in personal financial transactions would be met without unduly hampering legitimate law enforcement activities.

When we have completed our consideration, we will promptly communicate our views to the subcommittee, and you can be assured that you will receive them well in time for consideration as part of the markup you plan to hold on this matter, after the return of the Congress from the August recess.

Mr. Chairman, that is a summary of my written statement. I will be happy to answer questions.

[Testimony resumes on p. 970.]

[The prepared statement of Mr. Gardner follows:]

STATEMENT BY THE HONORABLE STEPHEN S. GARDNER
DEPUTY SECRETARY OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS SUPERVISION,
REGULATION AND INSURANCE
HOUSE COMMITTEE ON BANKING, CURRENCY AND HOUSING
MONDAY, JULY 21, 1975, 10:00 A.M.

Thank you, Mr. Chairman and Members of the Committee:

I am glad to appear today in response to your request for the views of the Treasury Department on H.R. 8024 and related bills. This proposed legislation covers a broad range of important financial topics.

Title I of H.R. 8024 would extend the authority of the regulatory agencies to limit time and savings deposit rates for banks, savings and loan associations, and savings banks from December 31, 1975 to December 31, 1976. This would prolong the ceilings for almost eighteen months, an extension which seems to me unduly long in view of the acknowledged need to replace artificial ceilings with more lasting and effective institutional reform. As you remarked on June 26, Mr. Chairman, "There has been increasing concern that Regulation Q, in fact, is creating distortions without achieving its primary purpose, i.e., insuring a steady flow of deposits in thrift institutions available for mortgage financing." Not only must action be taken to replace such makeshift programs as the ceiling authority with a sound, comprehensive financial institution reform act, but the public and the financial community must be given assurances that real reform will actually occur. We are pleased that your Committee will soon consider these and other matters as a part of the FINE study, and we look forward to participating with you in those deliberations.

Although the need for basic institutional reform was recognized over five years ago when the Hunt Commission began its deliberations, a positive program still has not

been implemented. I think we can all agree that we do not want piecemeal action or legislation. But a commitment should be made to a timetable for comprehensive action, and the extension of the ceiling authority provides the Congress with the opportunity to make such a commitment. There would be a positive benefit in limiting the extension of the ceilings to six months. This would provide your Committee with almost a full year to enact comprehensive reform. A six-month extension would be a clear signal to the financial community and their regulatory agencies that such reform is imminent.

Title II of H.R. 8024 extends the life of the EFTS Commission and its deadlines for reporting. I wholeheartedly support this provision. This Committee has been justifiably concerned, as has the Administration, by the delay in appointing the Commission, and I am happy to say that you can expect official announcement of the Commission in the very near future.

However, I want to make it clear that this delay was not because this issue is not important to the Administration; quite the contrary. As the Committee knows, the enabling legislation sets forth strict and specific restrictions on the selection of public members. The delay simply reflects the difficulty in locating highly qualified individuals who met the statutory requirements and were willing to undertake the task. Several excellent and well qualified candidates requested that their names be removed from consideration when it was determined that fee-paying directorships or consulting contracts would have to be terminated in exchange for the very modest per diem compensation offered by the Commission.

While the Department supports the extension of the Commission's life contained in Section 201, we do have strong reservations about some of the other aspects of the Title. For instance, Section 202(A) makes a finding that the Commission needs the authority to monitor and control all EFTS experimentation. The Commission was conceived as a study group, and we believe that its functioning would be less effective if it also were given regulatory functions. Sufficient authority already exists in the present agencies for the exercise of all necessary controls. The EFTS Commission can provide valuable assistance in summarizing and analyzing electronic fund transfers experience, and I expect that it will provide specific recommendations for legislation.

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Mr. Chairman, in your opening statement on July 16, you stated, "the use of the word control in the bill was not intended to indicate that the Commission would take over from the regulatory agencies the authority to approve EFTS experiments or to second guess such approvals." We fully support that interpretation; however, we believe that the legislation as currently drafted is inconsistent with the Committee's intent as stated, and we strongly recommend that it be amended to clarify the matter.

EFTS is not a new concept. It is the result of an evolutionary process, an outgrowth of our growing ability to process and manage data efficiently. As new technology has provided us with the means to automate all record systems, the need for simplifying the increasingly complex funds transfers of a growing economy has simply grown apace. The financial system over the past hundred years has evolved from the use of generalized paper bank notes to the use of individual personal checking accounts to transfer bank liabilities from individual to individual. As the affluence of our people has grown, we have had to develop more efficient means of transfering funds between banks and individuals. Machine coding and processing or paper checks is just one example of this evolutionary process. Increasing transaction volumes and the growth of credit card transfers have encouraged, if not necessitated, a shift from the use of paper to that of electronic funds transfer because of the lower cost, reduced handling and storage needs, and greater efficiency of the latter.

Mr. Chairman, electronic funds transfer systems do not represent a fundamental and revolutionary change which will require a sudden, extensive adjustment in our present means of conducting business. They are simply another evolutionary step for our financial payments system. For example, there is lockbox banking for gasoline and oil company credit card purchases. The physical receipts are rarely if ever seen by the company, but instead are deposited directly with the commercial banks, which notify the company electronically by telephone or telex or non-electronically, by mail. Similarly, the use of credit cards has been enhanced over the years with the installation of electronic equipment to verify account status quickly and efficiently. Sears-Roebuck no longer has need for thousands of file cabinets to house handwritten account status cards and their customers are served more quickly and efficiently. The use and functioning of their credit card, though, is essentially unchanged.

Certainly there are a number of important issues with which the EFTS Commission must deal -- preserving and promoting competition, preventing unfair or discriminatory practices, assuring consumer convenience and privacy. Still, we must remember that the evolution of electronic data processing began decades ago, and is continuing, enhancing our abilities in science, education, communication, and all areas of man's knowledge and needs including, of course, the financial system.

Title II directs the Commission to prepare a report within 90 days containing: (1) recommendations for further legislation enabling it to carry out its functions, (2) a proposal for monitoring all EFTS experimentation, and (3) methods for evaluating such EFTS experimentation. Although we feel that the Commission should evaluate significant experimentation in the EFTS area, I do not think that a competent, complete job can be accomplished by the Commission within a period of only three months. In addition, we feel that it is too early for the Commission to recommend strict limits on experimentation. In view of this, we could support a recommendation that the Commission be asked to present a report within a period of six months. Included in the report would be: (1) a review of the status of EFTS experimentation, (2) a discussion of the implications and (3) any recommendations for Congressional action. This report would be in addition to the reports already required by P.L. 93-495.

Title II also directs a moratorium on EFTS experimentation during this 90-day period until the preliminary report is completed. We strongly oppose such a moratorium. The pace of EFTS experimentation is moderate at present and would not significantly increase during the time period needed for the Commission to prepare its preliminary report. A moratorium would be neither relevant nor practical, and would unduly penalize those institutions which have already planned or begun needed EFTS experimentation. There is a certain illogic in directing the Commission to study EFTS experimentation and simultaneously prohibiting the experimentation itself.

Title III contains the proposed Mortgage Disclosure Act of 1975 which requires depository institutions to compile and disclose to the public information on commercial and residential real estate loans and savings, by census tract, during each fiscal year.

Arguments have been set forth opposing this legislation on the basis of excessive cost and because of the uncertain value of the statistics which would be derived. While I share some of these concerns, I believe that the questions raised by the legislation are much more far-reaching and fundamental. They involve a basic assessment as to where the responsibility lies as we all seek to maintain and restore our urban neighborhoods.

Certainly the deterioration of the housing stock in our central cities is a major concern which must be addressed. It is equally true that one of the keys in resolving this problem is the ability of property owners to obtain financing to buy, repair, improve and sell such housing. However, the responsibility to help maintain and restore our urban neighborhoods does not lie solely with the nation's private financial institutions. They are only one part of the equation. Equally important is the involvement of the local city governments and the neighborhoods themselves. These three groups make up an important triumvirate if the dilemmas of urban decline are to be met. The fact is that financial institutions must also be concerned about their depositors, whose funds they are obligated to protect. If they are asked to act alone in a neglected neighborhood, they could endanger depositors' assets and they could also be very unsuccessful. There must be a commitment from the neighborhoods themselves for restoration, and the city must be willing to join with appropriate commitments and services.

I want to make one other comment on Title III. In attempting to compare the source of savings and the granting of residential real estate loans on a geographic basis, there is a clear implication that a parity between the two numerical results would be desirable and that deposits should be reinvested in the community of origin. One of the major strengths of our economy is our vast and flexible capital market where funds can and do flow from capital rich to capital poor areas, and specifically from areas where housing funds are in surplus to those where they are deficient. Certainly, we should avoid any suggestion that this reverse flow of funds back to the city should not be encouraged. The key is to make sure that our capital markets are strong enough and flexible enough to meet our needs.

I do not mean to suggest, by any means, that financial institutions, or for that matter other private corporations, governmental units, community groups or individuals should neglect the problems which confront us all. We all bear some responsibility for their creation and only by working together can we resolve them.

Finally, I would like to make one comment related to the various bills you are considering concerning the confidentiality of bank records. The Administration is keenly aware of the interest in the Congress in establishing a set of rules governing the confidentiality of financial records and access to such records by Federal and State law enforcement agencies. Treasury is working with other executive departments and the Domestic Council Committee on the Right of Privacy to arrive at a balanced legislative proposal which would assure customers of financial institutions that their reasonable expectations of privacy in their personal financial transactions will be met, without unduly hampering legitimate law enforcement activities. When we have completed our consideration of the proposals, we will promptly communicate our views to this Committee, and you can be assured that you will receive these views well in time to consider them as a part of the mark-up you plan to hold on this matter after the return of Congress from the August recess.

Thank you.

I would now be happy to answer questions.

Mr. ST GERMAIN. Thank you, Mr. Secretary. You referred to an inconsistency in title II. I find some inconsistencies also. When title III came about, the midwives or obstetricians who gave birth to it did so because of an existing problem in many areas of the country.

Now, in your statement I wrote down these following words, where the traditional role of capital or housing funds are in surplus they move to areas that are in need. Well, the point of title III is to determine whether there is a surplus of housing funds. If there is a surplus of housing funds in an institution that services and gets most of its deposits from or should service and get most of its deposits from a disinvested area, then this is an inconsistency in and of itself.

We are not looking for any direct relationship in this legislation between deposits and reinvestment. We are merely looking to determine, or to give an opportunity to the residents of the area who are depositors in these institutions, to determine whether in fact a fair amount of the funds in their opinion is being reinvested in the area. That is all. That is what this is all about. We do not ask that the prudent man rule be done away with.

Am I correct in saying this, that 97 percent of depositors of financial institutions are covered by the $40,000 insurance on their deposits?

Mr. GARDNER. I do not know that exactly but I would think you are correct. It is my experience that you would be substantially correct, Mr. Chairman.

Mr. ST GERMAIN. With respect to regulation Q, do you object to the length of the extension? Does that mean that you are now in disagreement with the recommendations of FIA, that there be a 5-year extension of regulation Q?

Mr. GARDNER. No, sir.

Mr. ST GERMAIN. Now, is that not an inconsistency? The administration is looking for 5 years now with a review thereafter. So, what is wrong with 18 months?

Mr. GARDNER. I want to get the Financial Institutions Act enacted, Mr. Chairman.

Mr. ST GERMAIN. So, in other words, you are making it 6 months and using that as a blackjack, would that be it?

Mr. GARDNER. No, that is your term, sir, I would not consider a blackjack. I do think that there are so many special interests involved in the Financial Institutions Act, there is so much controversy, there are so many people who are interested in that sort of financial institutions structural reform that the Congress and hopefully the administration should take the lead in enacting something as carefully drawn as the Financial Institutions Act. I would hope we would set a time schedule, sir, to get that done within a year. I think if we allow another 18 months we would give a signal to all of these people who are so interested in the act that it will drag on.

Mr. ST GERMAIN. Well, the FIA was amended this year from last year to include credit unions, is that correct?

Mr. GARDNER. Yes, sir.

Mr. ST GERMAIN. The original FIA did not realize that credit unions existed.

Mr. GARDNER. We tried to remedy that.

Mr. ST GERMAIN. So, the administration itself found that there were some deficiencies in the original legislation.

Mr. GARDNER. We have some good provisions in the Financial Institutions Act for credit unions.

Mr. ST GERMAIN. Well, I am very, very, happy with it. As you know, the Hunt Commission was appointed in 1970.

Mr. GARDNER. Yes, sir.

Mr. ST GERMAIN. The report was submitted December 1971 to the administration, to the President. And in August 1973 we were told that, well, here is a little rundown on this report and we are going to be submitting some legislation to you in 18 months, right?

Mr. GARDNER. Yes, sir.

Mr. ST GERMAIN. And all we had involved there were Treasury, FDIC, the Comptroller, the Fed, the FHLBB, and the administration, the five major agencies?

Mr. GARDNER. Yes, sir.

Mr. ST GERMAIN. So you are asking 435 members of the House and 100 Members of the Senate to get together more expeditiously? These are the practical problems that we here in the Congress are facing with FIA and I would like to commend that to your attention. This is why, frankly, the regulation Q extension was put in for 18 months. We tried to be realistic about this.

Now, you say that regulation Q causes a less stable and steady flow of funds in home mortgage financing. If that were the case, why does FIA recommend an additional 6 months' study after 5 years to determine whether it should be extended even further?

And, would you also tell the subcommittee how FIA insures a steady flow of mortgage financing?

Mr. GARDNER. Well, Mr. Chairman, we have felt that financial institutions' structural reform was a very important subject. Great organizations and industries have grown up, have expanded under the provisions of regulation Q. This has been part of our economic system for some time and so, in order to make such major structural reform and to find a fair basis for implementing that structural reform we included in the act a provision that the regulation Q ceilings would be phased out. In the later act, the ceilings would not necessarily be phased out but would be eliminated after a period of 5½ years, subject to a review. We believe that is a fair way to effect major structural reform.

There is no conflict in my statement with respect to the extension of the present regulation Q. None whatsoever because I hope that extension would coincide with enactment of the Financial Institutions Act. We still perceive that to be fair and equitable the way to proceed is by leaving the regulatory authorities with authority to set ceiling rates on savings interest over a period of 5½ years.

Now, your second question, why a study?

Mr. ST GERMAIN. No. The second question, actually, is in which way does FIA insure a steady flow of mortgage financing?

Mr. GARDNER. Well, we think that it provides some competitive opportunities and increased viability.

Mr. ST GERMAIN. You mean the checking accounts and the lending powers of the thrift institutions?

Mr. GARDNER. Correct, for the financial institutions that are normally called thrift institutions, it gives them an opportunity to adjust their flows of funds. Their sources of funds and their invest-

ment of funds will be helped by the ability to pay higher rates which are more market oriented and by the ability to have more flexible investments.

Mr. ST GERMAIN. Those are rates on deposits?

Mr. GARDNER. Yes, sir.

Mr. ST GERMAIN. When do you anticipate that would happen?

Mr. GARDNER. When do I anticipate what?

Mr. ST GERMAIN. An even greater return to the consumer-depositor.

Mr. GARDNER. At the moment, considering the present level of interest rates, I would not expect that there would be an increase. We are all very conscious of the periods of tight money that have occurred in the last few years. When the thrift institutions were stopped from paying higher rates and were locked in with heavy portfolios of fixed rate obligations.

So, we think that by broadening the powers of all of the institutions that they will have more flexibility to meet money market rates.

Mr. ST GERMAIN. When do you think that that might occur, this ability to pay more, not to the CD depositors but to the average depositors. In other words, the large percentage of customers that are covered, as you said earlier, under the $40,000 insurance?

Mr. GARDNER. Well, the period in the Financial Institutions Act, while not one that I picked, is 5½ years. It would give the institutions sufficient time to build a portfolio of consumer loans, and other money market instruments. I would assume that perhaps midway through that 5-year period they would be competitive.

It is a difficult question to answer, Mr. Chairman.

Mr. ST GERMAIN. Well, that is the answer we get from everyone and this is why I keep asking the question of our witnesses as to when you think the consumer depositor will benefit by way of an increased interest rate.

Mr. GARDNER. Well, you have my answer, sir. I think by midway throught the period they will obviously be beginning to benefit.

Mr. ST GERMAIN. Frankly, you are the first one, and I commend you to even attempt to answer it.

Mr. GARDNER. It is a very subjective question, Mr. Chairman.

Mr. ST GERMAIN. Mr. Gradison?

Mr. GRADISON. Thank you, Mr. Chairman.

I would like to pursue briefly this question of urban disinvestment. It of course has been brought forcefully to our attention by representatives of neighborhood groups and several mayors. Last night, in my district, I was talking to a savings and loan executive in an association which has about $40 million in assets. We have a large number of small associations in our area. They ran their own check using ZIP code data and discovered several intercity neighborhoods in which the investments that they had made were substantially in excess of the amount of savings in those neighborhoods. And they started to ask some questions.

Now, what is the implication of this legislation if we have $2 million of investments in mortgages in a neighborhood where we have $1 million in savings? Does this imply that we are somehow out of balance if the argument is being made that if we have $2 million of savings and $1 million of investments there is some incongruity? I am really concerned about this because it, of course, not only has implications with

regard to where funds should go from neighborhood to neighborhood but from city to city.

Do you want to expand at all on your comments about this matter and what impact it might have on the flow of funds for housing?

Mr. GARDNER. Well, I would like to cite a very rough example. In the 1960's, California, a growing, healthy State with a huge demand for new mortgage funds, advertised in many eastern newspapers offering high rates for savings. This is an example of the national flow of funds that I talked about. A capital-rich area, presumably the East, was supplying a capital-poor area. The California thrift institutions seemed to be able to offer much higher rates and carried out a substantial amount of advertising to attract savings from Eastern States.

This flow of funds should not be impeded, in my judgment. One of the great virtues of the United States is that there are very few barriers to commerce and finance throughout all 50 States. The California experience is sort of a reverse example because I am sure the funds were used to build middle-income housing, but nevertheless, it is indicative of the fact that savings and capital funds do flow from one area to another.

I think if we involve ourselves with census tracts and the implication that a financial institution should invest in the neighborhood from which it draws deposits, we will find many surprises. In the first place, I do not think that the information will be perceived as relevant by the depositor. I have had a lot of experience in the financial community and have come to the conclusion that the depositor is interested in receiving a fair return and knowing that his deposits are safe and well invested. Those depositors who are interested in having their own money used for experimental purposes are not very numerous, in my opinion. If we go forward with this proposal we are obviously developing the assumption that all Americans are totally involved, socially minded and committed to saving the inner city. I think the assumption is valid on a theoretical basis. I also think we have practically acted on these concepts in our own businesses and our work. However, when we initiate programs that rely on what we think depositors would desire in the useful investment of their funds, I think we are making an assumption that is not valid. I am not sure that individual depositors would generally approve of all financial institutions simply returning deposited funds to the same neighborhoods from which they were derived.

We have a very flexible financial system in the United States. And I very deeply believe that when neighborhoods and local government and the financial institutions join together in some form of consortium effort to get rid of blight or to restore neighborhoods. We have a fine and excellent chance of achieving those goals. I have seen this bubble up time and again. Many efforts have been made along these lines. Unhappily not all have been successful, but we should not give up just because one program or another did not succeed. We should keep working on those programs.

My point, Mr. Congressman, is simply that we need a total community effort to restore neighborhoods and the only way to do this is in consortia.

Mr. GRADISON. One final question on this same subject; if, in a given city, there is a perception that certain communities are riskier than others, have more social problems, more economic problems, and so forth, is it not possible that once these data are made available as a result of the proposed bill, that associations might advertise that they make an unusually high percentage of investments in neighborhoods which are considered "safer" and thereby use this as a means to try to attract savings away from associations that make a higher percentage of their investments in neighborhoods which might be considered more troubled?

Mr. GARDNER. Well, I suppose it is possible, but I would not like to be involved with a financial institution that made that statement if they had any concern about the community and their public image.

Mr. GRADISON. Well, it becomes public record once we get this data out. I think we have got to consider not only what effect it has in making the information available to neighborhood groups so that they can try to bring pressure to change the investment habits of associations, but I think we also have to at least think through what implications, if any, it may have with regard to the preferences of the savers. I mean we are assuming all along that the savers do not care; maybe they do, especially with uninsured associations.

Mr. GARDNER. I do not think that we should simply take comfort in the fact that deposits are insured up to a maximum limit of $40,000. The correlary of that is it does not really matter where financial institutions invest their funds and I do not agree with that.

Insurance has been extremely useful in the United States. It is a great innovation to have small depositors' savings and checking accounts insured. I think it is highly desirable, but I do not think the insurance program was designed to permit the financial institutions to indiscriminately invest.

Mr. GRADISON. Thank you, Mr. Chairman.

Mr. ST GERMAIN. I would just like to inject that when I mentioned that I also mentioned the fact that because the prudent investor rule would still apply, no one intends to say, that because there is $40,000 insurance, that any type of investment goes. But you still look at the credit worthiness of the applicant and condition of property, and so forth.

Mr. Fauntroy?

Mr. FAUNTROY. Mr. Gardner, you responded at length to an inquiry by the gentleman from Ohio, Mr. Gradison, about the prospect of there being widespread patterns not unlike the specific example which he cited of relatively low savings in an area of disinvestment to which more funds were being committed in terms of reinvestment. The overwhelming experience of at least the mayors who have come before us and the Governors has been much like that in the District of Columbia where a recent study documented the fact that the savings and loan institutions in the city commit 88.4 percent of the money outside of the city at a time when the one company, S. & L., which decided to invest 75 percent of its funds in the city had the highest rate or the best record with respect to repayment of those loans.

That is refuting the argument that the areas of disinvestment are somehow high risk areas. How do you account for that kind of situa-

tion which apparently exists not only in Washington but in a number of communities across the Nation. What is necessary to correct that kind of situation, short of what is being proposed by the subcommittee or by the chairman here?

Mr. GARDNER. Is your second question, what do I think is necessary to correct the situation?

Mr. FAUNTROY. I would like the first question answered first: How do you account for the fact that there are many communities across the Nation that are the exact opposite of what the gentleman from Ohio raised as a pattern, at least in one instance, and as result of one conversation with an S. & L. director—how do you account for that fact, particularly since for those who do invest, at least in this area, those investments in the inner city tended to be among the most secure investments?

Mr. GARDNER. Well, I am not acquainted with the facts that you recited but I would have no quarrel that intelligent investing can be done in the inner city by financial institutions which are well organized and aware of the problems of investing in neighborhoods where property values are declining. I think it is possible to do that.

You do not surprise me by telling me that a financial institution that commits 75 percent of its funds to a less affluent area has the best record of foreclosures or perhaps credit experience. You do not surprise me at all because I think that is very possible and can be done.

Mr. FAUNTROY. Is it not ironic that in this case it happens where 88 percent of the funds committed by other S. & L.'s goes outside of that area, ostensibly on the basis of the fact that that area is high risk and therefore should be one characterized by disinvesment?

Mr. GARDNER. I am against redlining and share your concern. I want to mention one other thing here that may bear on your question. Institutions that specialize usually do a much better job than institutions that do not specialize. I believe that lending money in a particular area or neighborhood requires some intimate knowledge of the conditions in that neighborhood and therefore I am not surprised that an institution that specializes in a less affluent or a distressed neighborhood could be very successful. I think that is very possible.

The proposed legislation suggests, I believe, that every institution should automatically reinvest its funds in its own particular locale. And I do not think that implication, which is very strong in the proposal, is really the answer. There are many other things that must be done, including, as I have indicated before, an association with the city authorities and the neighborhood groups themselves. I have seen that work to some extent myself in my former city, Philadelphia.

I do not think we, in our wisdom in Government, can mandate simplistic answers such as the suggestion that every financial institution should return, without fail, a certain percentage of its deposits to the area from which those deposits came. I do not believe that is the way to get at the problem. There are other ways to resolve it.

Mr. FAUNTROY. Would you elaborate on some of the other ways?

Mr. GARDNER. Well, I am told that in Philadelphia that there is a group operating under the auspices of the development coordinator of the city which is trying to work up a system which would join the financial institutions, the city itself, and the neighborhoods together

in an attempt to restore neighborhoods which are probably far more depressed than the ones you are talking about. The group is developing a Municipal Assistance Corporation, not similar to New York's but a corporation which would insure a portion of the mortgages granted in the ghetto areas that are terribly distressed.

The community groups that represent those areas and the city that provides the services, will find willing partners, in my judgment, in the financial institutions if they develop a block-by-block or area-by-area program of that kind. We tried to develop such a plan with the State of Pennsylvania while I was still in Philadelphia and that plan did not quite work.

But, then as I have said, we do not give up, we just keep working on these plans. I think Secretary Hills has indicated in her testimony that there are governmental funds available for assistance programs of that kind. I looked briefly at her testimony and agree that we should try to develop those kinds of programs. Where the neighborhoods themselves and the city work with the financial institutions, you will inevitably get cooperation.

Mr. ST GERMAIN. Will the gentleman yield at that point?

Mr. FAUNTROY. I will be happy to yield.

Mr. ST GERMAIN. The Philadelphia plan, have you studied it closely?

Mr. GARDNER. No; I have been trying to, Mr. Chairman, I have been away.

Mr. ST GERMAIN. Well, it basically relies on PMI—private mortgage insurance. Are you familiar with the Arthur D. Little study on PMI's?

Mr. GARDNER. No, sir.

Mr. ST GERMAIN. The study indicates that they have very serious difficulties. The problem is that the private mortgage insurance which is incorporated into this Philadelphia plan would be an additional fee charged to the borrower and could well result in rather substantial or exorbitant fees over and beyond the interest rate.

Mr. GARDNER. I was not aware that the current Philadelphia plan involved private mortgage insurance.

Mr. ST GERMAIN. That is the one done by Christopher Weeks?

Mr. GARDNER. Yes.

Mr. ST GERMAIN. Well, I think if you look at it closely you will find that reliance is placed upon private mortgage insurance. It is similar to the situation that was cited to us out in California. But there is reliance on PMI and I do not think at this point we can afford to place too much reliance upon PMI because of the difficulties that they are having.

I thank the gentleman for yielding.

Mr. FAUNTROY. Thank you, Mr. Chairman.

Mr. ST GERMAIN. Mr. Patterson?

Mr. PATTERSON. Good morning, Mr. Gardner.

I am interested in pursuing this a little further and talking a little bit about the EFTS. You cited the California experiment and of money flowing in that direction, I am not sure what years or what era you are speaking of? Is that an ongoing thing now?

Mr. GARDNER. Mr. Patterson, it was not an experiment, I was just citing the fact that during the 1960's the California thrift institutions advertised heavily in the East for money.

Mr. PATTERSON. Did that money come from the average borrower?

Mr. GARDNER. I think indeed it did.

Mr. PATTERSON. Did it come from the larger financial institutions?

Mr. GARDNER. I was connected at the time with a financial institution and we saw deposits flowing to California for higher rates. I am sure I can document the period—it was from 1960 to 1966. I mentioned it solely as an example of the competition and free flow of capital funds.

Mr. PATTERSON. In regard to the reference to other ways; I fail to pick up any other ways. It seems you have got a problem at least in southern California where it is much more difficult to get a loan in the more densely populated urban areas even though they have public facilities, transportation is easier, the public utilities are installed. Funds seem to flow out to the outlying fringes and suburban areas, the uncleared lands, which continues the problem of urban sprawl and growth and also takes money from these central areas where the people are living. In fact, it encourages them to keep moving out further and further which compounds the air pollution and a lot of other problems there.

It is a form, it seems to me, of redlining that seems to encourage this and I am wondering if you would agree that the practice of redlining does encourage that type of growth?

Mr. GARDNER. I think redlining is a simplistic system which reflects the failure to carefully make a credit judgment. I think credit judgments can be made in declining neighborhoods. When you ask how we can get at the problem of urban sprawl, I am convinced that what you are talking about, is the economy of this country. We have been moving out of the inner cities and have built a whole green belt called suburbia. This is a sociological and economic trend. Most of us are now concerned that if our cities die, what will happen to our commerce, our culture? What happens to efficiency? Many efforts have been made, but I am still very much concerned about this even though I have seen progress in many ways.

Philadelphia has made a great deal of progress in gradually restoring areas that were ghettoized. The city has tried homesteading, it has tried all kinds of things. There is cooperative sensitivity in the city government and there is clearly in many instances neighborhood pride and willingness to cooperate. Neighborhood associations have become very vocal and well organized in recent times. This is kind of a new thing in our society.

I can assure you that from my experience, when financial institutions see an opportunity to participate in a consortium effort the majority are willing to do so because their headquarters and their commerce depends upon the life of the city in which they are located.

Mr. PATTERSON. I am trying to see what we might do, what the Congress might do, your agency might do to encourage healthy urban areas. It seems to me that this whole sprawl thing has led to urban decay unless we buy the concept that cities are to be built, run down and die, and everyone just keeps moving out where land is plentiful and it

does not matter how we use it. There is a need for financial institutions to get back in the city. Instead of moving out of the city they should put some roots down and go into the redevelopment of cities.

For example, in Santa Ana, my hometown, there are very little funds available to redevelop the city in spite of local government's effort, in spite of taking advantage of State laws, in spite of tax incentives. It is still difficult to get private mortgage money to do the redevelopment that is needed to tear down and build up a building because it is so much easier just to build a new building on virgin land than it is to go through the other process.

Mr. GARDNER. Well, I think the economics of the situation are now, after 20 years, beginning to work for us. Let me cite an experiment that I do know something about in the garment center in Philadelphia. The industry employs entry level workers, and needs to be located near its labor source and supply. A consortium of business, the city, financial institutions with some funding assistance from the Philadelphia Industrial Development Corp. and from the city of Philadelphia, have revitalized major industrial buildings, improved transportation facilities, police protection, lighting of the streets, and the like. Banks have joined in the financing arrangements in this attempt to save the needle trades in Philadelphia by restoring inner city factories to a place where people are willing to go to work, are not afraid, and have adequate transportation.

This is an ongoing experiment in Philadelphia. It happens to involve work and jobs but it demonstrates the kind of concept I am talking about. If all goes well, they will also assist in building the first new garment center building in the heart of a major city. This has great significance because, as you know, our garment industry has spread out all over the United States. It ran South, it went to Puerto Rico, it went anywhere it could achieve a tax advantage and cheap labor.

Now the industry is beginning to realize that it must come back to America, that it must come back to the traditional source of its labor supply. So I think the economics are beginning to work for us in this case in that the trends of the past 30 or 40 years are beginning to reverse.

[The following material of how the Philadelphia Garment Board had dealt with rebuilding urban areas submitted by Mr. Gardner at this point in the record follows:]

THE PHILADELPHIA GARMENT BOARD

From a high employment figure of 62,000 in 1966, the Philadelphia garment industry had dropped to 47,000 employees by 1971. Even at this point, however, the industry encompassed 6.5 percent of all jobs in the city and represented 20 percent of the city's manufacturing activity. If the industry were to continue its vital contribution to the economic well-being of the city, its problems required immediate identification and corrective action.

Initial assessment of the factors underlying the decline of the industry was undertaken by a group which included representatives of the International Ladies Garment Workers Union, The Philadelphia Industrial Development Corporation, a low interest funding arm of the city, and the Old Philadelphia Development Corporation, which is a nonprofit civic action group made up of businessmen, bankers and leading public figures. This group recognized that the physical conditions in the most densely populated employment areas were "beyond tolerable limits of obsolescence," with safety and sanitary conditions being totally unacceptable. Additionally, transportation to and from the employment areas was

difficult and even intimidating, especially after dark. Four thousand five hundred industry jobs were housed in buildings marked for demolition as part of the ongoing urban renewal program and obviously a successful relocation was essential to the survival of displaced units.

In April 1973, after two years of study, this pilot group issued its Garment Industry Proposal which recommended the establishment of a Garment Industry Board. The Mayor announced the establishment of this ad hoc board in June 1973, which can accurately be described as an extraordinary coalition effort. It is an industry-labor-government-civic organization equipped to draw upon the total resources of the community to meet the problems of the industry head-on.

The accomplishments of the board have been impressive and include among other things:

1. A model garment industry plant is now under construction. This building is being privately financed and privately constructed with the assistance of the Philadelphia Industrial Development Corporation. The building will pay real estate taxes.

2. *Garment Square.*—In an area of heavy worker concentrations at Broad and Lehigh in North Philadelphia, the Garment Board initiated a series of worker oriented improvements such as added police security, subway lighting, street lighting, area beautification and neighborhood improvements.

3. *Industry Services.*—The Garment Board utilizing its good offices has intervened for employers caught in highway condemnations, fuel cutbacks during the energy crisis, mercantile tax application on certain locally produced goods, urban renewal relocation, and dozens of other individual problems.

4. *New Business.*—The Garment Board has uncovered new sources of business from federal, state and local procurement sources.

5. *Research and Planning.*—The Garment Board has developed a program whereby the University of Pennsylvania will initiate studies into realistic growth potential, employee needs, and development of Philadelphia manufacturing employment.

It should be noted that last year the U.S. Department of Commerce through the Economic Development Administration awarded the Garment Board a $250,000 technical study grant to advance the industry stabilization efforts.

Mr. PATTERSON. OK. Let me ask you a question on the EFTS. You have indicated two things that seem a little inconsistent to me in your testimony. One is that you oppose a moratorium and, on the other hand, you encourage the promotion of competition. And I am just wondering how can the smaller financial institutions become a part of the EFTS system and what measures are being taken to see that they have some input because it seems to me that the larger institutions have really all of the research and all of the development that has gone into this. They will be able to take primary advantage of the EFTS system.

Mr. GARDNER. Are we talking about the off-premise terminals and the like?

Mr. PATTERSON. Yes.

Mr. GARDNER. I want to state from my own experience and background that dealing with a machine is no substitute for dealing directly with a bank or a savings and loan association or financial institutions. Incidental normal transactions can be handled but I do not think any of us would want to go through life simply dealing with a machine using encoded magnetic cards.

So, the expansion of terminals has been very modest at the outset. It is a very small number.

Second, the regulatory authorities have been, I think, extremely conscientious. Congress has made them very aware of the concern that there will be some new dangers to competition inherent in the development of the EFTS.

Third, one of the largest groups of customers of major banks are small banks and thrift institutions. Invariably, part of the customer activity of the major banks is the provision of access to electronic technology for their client banks and thrift institutions. This goes on all the time. Major banks often sell services such as the automating of the mortgage portfolio of a small thrift institution. This does not sound to me like monopoly. It sounds to me like evidence that we will continue to have a tremendous number of financial institutions in this country because the technology will develop further. It is true that, today much of the data processing equipment is financially beyond the reach of small institutions. But they are not suffering because they are able, on a competitive basis, to obtain these services from their correspondent bank, the major bank with whom they do business.

Mr. PATTERSON. It is sort of a cohesive thing. They have to take whatever is offered by the major institutions. It seems to me that the reason that you have the smaller facility is because you open up a branch closer to home. A larger bank has two or three in the city. And it just seems to me that if they are able to spread throughout the community with the computer terminals that literally wipes out the need for Barclay's Banks or some other banks that nobody else has ever heard of.

Mr. GARDNER. Well, Barclay's is one of the largest banks in the world.

Mr. PATTERSON. Well, the Patterson Bank, you have not heard of that one I am sure.

Mr. GARDNER. Well, I will try to answer that again, sir, by saying that local neighborhood banking is a tradition firmly ensconced in the United States and branching itself will never completely eliminate it.

Furthermore, in the local community bank there is person-to-person contact, and I do not think there is any opportunity for simply a mechanical computer terminal to replace this. I think that mechanical terminals are an aid to convenience banking but even though I have that kind of service available, I have never availed myself of it. A banking problem is one that needs discussion and cannot be handled over an automatic terminal. You know, one of our primary institutions for check cashing is the supermarket. Financial services are being offered in supermarkets today without any EFTS at all.

Similarly, I do not think that financial services offered by mechanical terminals will remove the competitive differences. In fact, I think smaller banks have the opportunity to be more competitive in this new age than they ever did in the years when I began in banking.

Mr. PATTERSON. Thank you, Mr. Gardner.

My time has expired. Thank you, Mr. Chairman.

Mr. ST GERMAIN. Mr. Johnson?

Mr. JOHNSON. Thank you.

Mr. Gardner, we are honored to have you here this morning. A fellow Pennsylvanian is always nice to have as a witness.

Two weeks ago the House killed a bill which had as its purpose, in effect, the allocation of credit. While it was not a compulsory allocation of credit, it was pointed out to be the first step. And it was an allocation of credit by programs. And I think the most important proposal in front of us today is the question of redlining reporting. That is a proposal which is allocation of credit, only it is allocation

of credit by neighborhoods rather than by programs. And, of course, when you allocate by programs, the theory is that you will not make the loan unless it is a good sound loan.

But here we have a situation where a hammer will be put on the heads of all depository institutions as they are called here, to step up their lending in neighborhoods where they are getting deposits from, irrespective of the soundness of the investment either from the neighborhood standpoint or from an individual standpoint.

At the last convention down here of the Mutual Savings Banks, I was just chatting with one of the mutual savings banks presidents and I said, "How is business?" He answered, "Oh, it is fine. We had $1 million surplus cash and we went out into the market and bought $1 million worth of mortgages." And I am just wondering whether if this redlining were to become law and institutions were admonished that they must loan their money into the areas where the deposits are coming from, will this have a dilatorious effect upon this mortage market for the banks who buy these mortages will not know particularly whether it was in an area that was declining. And it seems to me it would have a bad effect upon the market. What is your opinion on that?

Mr. GARDNER. Well, you know, sir, that I am against the idea of allocating credit irrevocably because I do not believe that our citizens really want credit allocation when they find out how directly it affects their lives.

Second, I think proposals of this kind do carry that implied indication that we are heading for a system in which some authority other than the private institutions and the individuals themselves propose to direct our resources in this Nation. I am against that sort of thing because I think our financial system and our economy itself is unique in history. It has developed as a result of competition in the private system.

So, I would have to agree that if we offer proposals which suggest that money should be reinvested geographically in certain percentages, we are again inserting the Government's presence into the free flow of our capital markets. And I would be against that.

I will add to that, however, that I think the problems that we are trying to address here are real. We should address them. We should address them in various ways, by providing governmental support in some instances by utilizing local governmental support, and by recognizing that communities develop by using the community resources. I think that development will occur and I perceive that it is beginning to happen.

Mr. JOHNSON. Last fall, Mr. Fauntroy had a bill which in effect would have permitted in the District of Columbia the establishment of a new town in town, as it were. And the bill failed on the floor. We do have housing legislation which would permit that kind of construction and I have always been a great promoter of the new in-town principle where an agency is formed and you go in and take a bulldozer and just level off about four or five blocks and then start from scratch, and build a small university and a school and a hospital and have areas for new home construction and senior citizen housing and so forth.

I personally think that is an answer to the redlining situation, and we should promote this new town principle even greater. I realize it

means taking somebody's property but if we are going to rehabilitate these deteriorated neighborhoods that is the type of drastic thing we have got to do rather than saying to the bankers, you have got to loan money out here whether you want to or not.

Have you given that any thought?

Mr. GARDNER. I have indeed. As I have said before, we have tried many things in this country. One of them clearly is the new town concept. I think we should persist in the development of these concepts even though individual instances of failure can be documented. I insist that we should not give up for that reason, never. Neighborhoods in Philadelphia utilized the new town concept—and excuse me for referring to Philadelphia so frequently—it has actually taken hold. There are others that have failed or have yet to take hold but I am convinced that when a concept of that kind is developed in the inner city with the support of the community and the city government itself and possibly Federal programs, that it is a very significant and important way to attack the problem. I think we should keep working on such projects.

There are areas where I have seen the new town concept work very effectively. If you develop a town or a center of this kind almost inevitably individual initiative follows on the perimeter bringing the beginning of a renaissance and of movement and I could document for you—I do not want to be too bold—but I could document street after street or block after block where the houses have been acquired, rebuilt, restored, and that is a great trend because it is moving in the right direction.

Mr. JOHNSON. Thank you. My time is up.

Mr. FAUNTROY. Will the gentleman yield?

Mr. JOHNSON. Yes.

Mr. FAUNTROY. I want to thank the gentleman for expressing that support for the Community Development Corporation concept which we floated last year. And let me assure you that in the District community it would have applied had it passed.

We already have acres of land that have been acquired and are ready for the disposition of new housing—thousands of units that are ready for 312 loan financing.

The problem is that we cannot get private investment from the saving and loan's in the areas; but, Mr. Gardner, do I understand that your opposition to this proposal is based on what you consider implied implications about credit allocation? It shouldn't be on that basis—of any specific mandate for credit allocation—as a part of this bill, because allocation is not mandate.

Mr. GARDNER. As I have indicated in my testimony, I recognize the fact that some people have complained that it is a costly procedure; and that it is an awkward procedure and that it would subject our institutions to a lot of additional Federal reporting.

But my opposition is philosophically on the basis that financial institutions should not be required, nor should it be assumed desirable that they invest equal percentages, or must invest equal percentages of their deposits in a percentage relationship to the areas from which they obtained those deposits.

Mr. FAUNTROY. You understand that is not specifically mandated by this bill. It is what you call an implied implication.

Mr. GARDNER. Yes, sir; I do.

Mr. FAUNTROY. Thank you.

Mr. ST GERMAIN. Mrs. Boggs?

Mrs. BOGGS. Mr. Chairman, I thank you.

I thank you so much, Mr. Gardner. I have no questions. I would like to comment on two things. One, that certainly revitalization is contagious. It always is. If you paint one house on the block, then all the others need painting. That has been one of the most exciting aspects of the redevelopment in the inner city in my home district of New Orleans.

It has been undertaken by young people, mostly, and with the backing of financial institutions. The other comforting thing that you said, of course, was that electronic data processing will never take over the personal aspect of banking, particularly in branch banking. In other financial institutions we found this most specifically in the flood insurance concept when we tried to have simplified methods of payments, just by check. We discovered that a great many people do not pay their insurance premiums by check; that someone goes around, still, to homes and offices and collects insurance payments. So that was a very comforting statement on your part.

If you do believe that consortiums are the answer, or the alternative to this bill, and if, as you said in your response to Mr. Fauntroy that financial institutions that specialize do better than financial institutions that do not specialize, do you have any suggestions for legislative action that we could take to make certain that financial institutions specialize in the high risk areas in the inner city?

Mr. GARDNER. I really do not have any suggestions at the moment. I would like to think about your proposal. I need to do more homework on the Federal credit programs that are available and which are supported, as you know in many instances, by the Treasury, through raising the funds in the capital market.

There must be a myriad of possibilities here among the various authorities and sponsoring agencies of local government and the like. Perhaps we should develop model programs which could be picked up by States, cities, and others, to help with this problem.

My main point is that we ought to do it through interaction and not, perhaps, direct our public attempts solely at the financial institutions. I think it ought to be done together.

Mrs. BOGGS. Thank you very much.

Mr. ST GERMAIN. Would the lady yield?

Mrs. BOGGS. Certainly, Mr. Chairman.

Mr. ST GERMAIN. No. 1, you would not want us to hold our breath until you come up with this new legislation, would you?

No. 2, concerning credit allocation, people have been throwing that word around here. There is really no thought whatsoever concerning credit allocation in this bill. But if you want to talk about credit allocations, how about the Emergency Home Purchase Assistance Act of 1974 where we put $10 billion into the secondary market? Was that not allocation of credit?

And, when we gave a tax credit for people purchasing new homes, was that not an allocation of credit to the housing industry? And are we not, in reality, allocating credit all the time in the Congress with the support of the administration?

Mr. GARDNER. Indeed we are, in many ways. Indeed we are. I am concerned that we not accept credit allocation in a much broader and definite way in this country.

Mr. ST GERMAIN. You see what this bill is, is an incentive to financial institutions. In other words, they publish where their money is going. By the way, on costs, you mentioned the cost to the financial institutions. Exactly what is the cost to the financial institution?

Mr. GARDNER. When I mentioned costs, Mr. Chairman, I said I know that others have objected on the basis of cost, and while I might share these views my principal objection is otherwise.

Mr. ST GERMAIN. If there are no other questions, we wish to thank Secretary Gardner. There may well be some questions submitted by members who could not be here because we have, I think, three Subcommittees of Banking and Currency conducting hearings this morning.

Mr. GARDNER. Yes, sir; I would be delighted.

Mr. ST GERMAIN. We thank you for your appearance, and for your assistance. When we send the transcript to you, we will also send some additional questions.

Mr. GARDNER. Thank you, sir. I want to thank you, Mr. Chairman, and the subcommittee. I thank you very much.

Mr. ST GERMAIN. Now we will hear from Hon. Frank Wille, Chairman of the Federal Deposit Insurance Corporation.

Chairman Wille, and members of the subcommittee, Chairman Wille has given us quite a few statements in reply to our request. There is a statement on H.R. 8024 and related legislation. There is a statement on bank privacy legislation. There is a statement on bank failures, supervision and regulation, with particular reference to USNB or Franklin National, on which we have had previous hearings.

I would ask unanimous consent that we place these statements in the record in their entirety. Without objection, so ordered.

Now in order to try to keep some semblance of order and to make some continuity in the record, we would ask you at this point, Chairman Wille, to summarize your statements on the legislation that we have been discussing with Secretary Gardner, on the extension of regulation Q, the EFTS moratorium, the disclosure legislation, and also on the legislation on bank privacy.

If you will summarize that, we will then question you in those areas, and then we will go on to the next areas. I might inform the subcommittee that Chairman Wille and the FDIC have been working very diligently to respond to our requests for assistance and testimony and we will have forthcoming probably after the luncheon break, additional testimony on supervision and regulation in the form of recommendations.

STATEMENT OF HON. FRANK WILLE, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Chairman WILLE. The supplemental statement that is coming, Mr. Chairman, relates to the question of bank regulatory agency reform. And the statement that I wish to submit for the record on that subject will be forthcoming within the next hour or two.

Mr. ST GERMAIN. Thank you. You may proceed to summarize your statement on the legislation.

Chairman WILLE. I think, Mr. Chairman, that could be briefly done with respect to H.R. 8024 and I would do it in this way.

The Corporation supports a 1-year extension of the statutory authority for regulation Q, as contained in H.R. 8024. This is a 1-year extension from December 31 and we would expect that by that time the 1-year extension will make greater and greater sense.

With respect to title II, which relates to EFTS matters, obviously we would support the extension of the life of the proposed National Commission on Electronic Fund Transfers. We do, however, have serious reservations with respect to the all-inclusive 90-day moratorium which the bill proposes to enact while it awaits some preliminary recommendations from the Commission.

The Commission has not yet been appointed, as you know, and we share the doubts previously expressed that within the 90-day period, the Commission will be able, on a part-time basis, to make the review which is contemplated by the legislation.

With respect to moratoriums generally in this area, we believe that one of the basic questions to be answered has to do with whether or not these particular facilities should be considered "branches" under Federal banking law. We recognize this is a thorny issue and one on which the Congress as well as the different regulatory agencies might have differing views.

On the other hand, we believe that if the Congress wishes to leave that question to the courts of the country, where it will undoubtedly be decided in due course, a moratorium pending that decision, or a moratorium which would prevent experimentation and technological refinement and improved customer service, would be a disservice to the public.

However, we believe that an intermediate position could be taken by the subcommittee, if it so wishes, in which the subcommittee might distinguish between the intrastate operation of EFT facilities and the possible interstate operation of such facilities.

We believe that the latter can be more readily frozen for a temporary period of time than the former, and we would recommend that the subcommittee give serious consideration to that.

Our position, summarized at the bottom of page 7 on my statement on H.R. 8024, is that we oppose the present moratorium imposed by the terms of the bill and would urge, instead, explicit guidance on whether or not such facilities constitute branches under present law for purposes of applying the provisions of State law which might govern their location and approval.

If this appears neither desirable nor feasible, and the Congress believes some moratorium should be enacted while it awaits the report of the National Commission or a judicial determination of the branch question, we recommend that the moratorium not apply to the establishment of such facilities intrastate, but only to the establishment of such facilities across State lines.

We obviously stand ready to help at any time, if the subcommittee desires our technical assistance in drafting legislative provisions on which it might ultimately decide.

With respect to title III of the bill, we share some of the reservations previously expressed by Mr. Gardner, while opposing, obviously, the discriminatory practice of redlining which, to the extent it is proceeding, is a practice which does not take into account differences of credit standing among borrowers in redlined areas.

We have reservations about title III largely because we doubt that the information requested will actually tell much about the reasons why a particular area has been excluded from certain lending by a given institution.

We have had some experience in this among the four bank agencies. For the period from June 1, 1974, through November of last year, we conducted a survey, on a joint basis, in 18 metropolitan areas and collected data with respect to ZIP code location of residential mortgage loans, for purposes of title VIII of the Civil Rights Act of 1968. This information has been collated for 12 of those metropolitan areas and the results of that collation have been released.

By and large we are not satisfied that the information we requested provided much of a handle on the existence of discrimination in these areas. On the other hand, we have yet to have the results of the different system of data collection imposed by the Federal Home Loan Bank Board in the remaining six areas and we would like to review that information before deciding what our next course should be in order to achieve the goals of title VIII of the Civil Rights Act of 1968.

This is a complex area and it is not easily given to simplistic solutions, as Mr. Gardner quite properly pointed out. We would suggest, in any event, that title III not apply to commercial real estate ventures, but rather only to residential mortgage lending, which I believe is the general focus of the subcommittee's attention.

At the very conclusion of my statement, I made the point that the assumption that construction lending or other loans on commercial real estate should be confined to the localities where a financial institution has an office or branch, is not valid in our opinion.

Likewise the assumption that financial institutions have a duty to make mortgage loans in a locality in direct correlation to the amount of savings and time deposits received also is questionable. Lending institutions have an obligation to their depositors to exercise prudence and sound judgment in the investment of funds and cannot ignore factors affecting long term values and loan security solely because of the amount or number of deposits received from a particular locality. In fact, if any such specific correlation between deposits and loans were to be required, the probable effect would be to afford a relative advantage to those institutions which make the least effort to provide savings facilities and other financial services in declining neighborhoods; and, therefore, to discourage the location of branches and similar facilities in such areas.

With respect to the privacy bills which are before the subcommittee, I sent the chairman a letter on July 18 outlining our general views on three different bills. We are in general agreement with the stated purpose of the bills, to preserve the confidential relationship existing between financial institutions and their customers.

Our principal concern in reviewing the three bills identified in your letter was that this protection of the confidential relationship between

financial institutions and their customers be effected in a manner that will not seriously hamper the supervisory and enforcement functions of various Government agencies.

And, to that end, we have suggested specific amendments to each of the three bills and they are outlined in some considerable detail in my letter. We find that we could support that legislation if the suggested amendments are incorporated. And again we stand ready to provide technical assistance to the subcommittee if it should desire the assistance of the Corporation.

[Testimony resumes on p. 1168.]

[The prepared statements along with attachments of Chairman Wille, follows:]

FDIC NEWS RELEASE

Statement on

H. R. 8024, 94th Congress

A bill "To extend the authority for the flexible regulation of interest rates on deposits and share accounts in depository institutions, to impose a moratorium on the usage by financial institutions of electronic methods of funds transfers, and to improve public understanding of the role of depository institutions in home financing."

Presented to the

Subcommittee on Financial Institutions,
Supervision, Regulation and Insurance
Committee on Banking, Currency and Housing
House of Representatives

by

Frank Wille, Chairman
Federal Deposit Insurance Corporation

July 21, 1975

Mr. Chairman, I welcome the opportunity to appear before your Subcommittee today to present the views of the Federal Deposit Insurance Corporation with respect to H. R. 8024, 94th Congress, a bill "To extend the authority for the flexible regulation of interest rates on deposits and share accounts in depository institutions, to impose a moratorium on the usage by financial institutions of electronic methods of funds transfers, and to improve public understanding of the role of depository institutions in home financing."

Extension of Interest Rate Authority

Title I of the bill would extend for one year (until December 31, 1976) the statutory authority presently vested in the Board of Governors of the Federal Reserve System, the Board of Directors of the Federal Deposit Insurance Corporation, and the Federal Home Loan Bank Board to regulate in a flexible manner the rates of interest or dividends payable by insured banks on time and savings deposits and by members of the Federal Home Loan Bank System on deposits, shares, or withdrawal accounts.

On a number of occasions recently the Corporation has gone on record as favoring the elimination of these Regulation Q-type interest rate ceilings on deposits as part of the Administation-proposed Financial Institutions Act (S. 1267, H. R. 5618 and H. R. 5619). While gradual elimination of these ceilings might be accomplished by administrative action, we believe that under present circumstances a total elimination of such restrictions could more appropriately be effected as an integral part of the Administration's proposed legislation. While we would urge prompt enactment of the Financial Institutions

Act, we recognize that it is unlikely that the Congress will be prepared to act on the Administration's proposals prior to the present December 31, 1975 expiration date of the agencies' flexible statutory authority to limit deposit interest rates. In view of the probable disruption that could result from a termination of deposit interest rate ceilings on that date, we would support a one-year extension of this statutory authority as provided for in H. R. 8024.

Electronic Funds Transfer*

Title II of the bill would extend the life of the National Commission on Electronic Fund Transfers created by Pub. L. 93-495 so that the Commission's final report would be due within two years after Senate confirmation of the Commission's Chairperson, rather than two years after date of enactment (October 28, 1974) as the law presently provides. Title II would also impose a 90-day moratorium on the approval by any Federal agency regulating insured financial institutions with respect to the establishment or expansion of any system utilizing an electronic device for the purpose of authorizing the transfer of funds in a depository institution. Within the 90-day period, the National Commission would be required to review all existing EFT systems and all applications therefor on file with the financial regulatory agencies and to make recommendations for any further legislation needed to carry out the Commission's functions, including --

> "the Commission's proposal for monitoring all experimentation occurring with respect to all electronic fund transfer systems, the number and location of such experiments by class of financial institution, the Commission's method of evaluation including potential cost savings benefits to the public and the means to be employed by the Commission to insure a uniform system of experimentation." (§ 203)

*The Comptroller of the Currency, who serves as a member of the Corporation's Board of Directors, has submitted a separate statement of his views on Title II directly to the Subcommittee in his capacity as Comptroller of the Currency.

Before broaching the substantive issues involved in Title II, I would like to call attention to one major technical deficiency in that Title as presently drafted. As noted above, the 90-day moratorium on EFT expansion, which would be imposed by § 202(b) of the bill, is phrased in terms of a prohibition against Federal agency approval of the establishment or expansion of EFT facilities by insured financial institutions. Insofar as such Federal agencies interpret existing law as not requiring their approval for the establishment of EFT facilities, as does the Comptroller of the Currency under current rulings, the 90-day moratorium as presently worded would not seem to have its intended effect. By way of further technical comment, it might also be pointed out that § 202(c)(2), (3), and (4) define terms which are not otherwise used in Title II.

Title II is designed to give the recently authorized National Commission on Electronic Fund Transfers a brief opportunity to study this area and submit preliminary recommendations to the Congress before allowing insured financial institutions to proceed with the establishment and operation of such off-site EFT facilities without regard to Federal and State laws on branch banking. The threshold question for the three Federal bank regulatory agencies (Comptroller of the Currency, FDIC and Federal Reserve) is whether some or all such off-site facilities must be treated as "branches" under Federal banking law. The reason this question is so important is that if they are "branches" under Federal banking law, the three Federal bank regulatory agencies will then be legally bound by the provisions of State

law governing the location and approval criteria for EFT facilities which banks headquartered in that State may wish to establish. If they are not "branches" under Federal banking law, the FDIC with respect to State non-member banks and the Federal Reserve with respect to State member banks would have only limited authority to supervise developments in this area unless some injury to the safety and soundness of individual institutions could be demonstrated. Presumably, notification requirements could be imposed on State-chartered banks which would allow the FDIC and the Federal Reserve to monitor the location, cost, operation and competitive impact of such facilities but advance approval or approval conditioned on certain changes in the planned operation of such facilities, e.g., in the terms of access to an inter-related network of such facilities, might not be possible. By contrast, the Comptroller of the Currency for national banks and State banking authorities for State-chartered banks would most likely have more comprehensive powers over the development of such facilities by virtue of their status as chartering authorities and primary supervisors for such banks. The Federal Home Loan Bank Board is not bound, as you know, by any similar provisions of Federal or State law in permitting federally insured savings and loan associations to establish branch or EFT facilities, since its governing statute is totally silent on the subject.

Of the many questions raised by EFT facilities, one appears to us to be relatively inconsequential, and that is whether a typical branch application and investigation should be necessary for these facilities even if they are to be considered "branches." We at the FDIC believe, and I am certain the other Federal supervisory agencies would respond

similarly, that simpler forms and a different kind of review are desirable for EFT facilities than for manned, full-service branch facilities. That question is basically administrative, not legislative, and the four Federal agencies would undoubtedly adapt their present branch application procedures to the special needs of the new electronic environment.

On the merits of Title II of H. R. 8024, our view is that rather than imposing a moratorium on the expanded use of EFT equipment, which might prevent experimentation, technological refinement, and improved customer service, we would prefer that the Congress give the Federal bank regulatory agencies explicit legislative guidance on the "branch" issue and hence on the applicability of State law. If, however, the Congress should prefer to await the National Commission's report, or a judicial resolution of the "branch" question, before enacting legislation in this area and decides to pursue the moratorium approach, we believe that it would be inequitable to impose a complete moratorium on the development of EFT facilities by insured and regulated financial institutions when uninsured and unregulated firms in the private sector are not similarly constrained, e.g., nonbank credit card firms and major retailers.

Within many States, in ways fully consistent with State law, commercial banks and thrift institutions have already committed significant resources to the various types of EFT facilities, many of which are presently or nearly in place. In view of the significant policy issues to be dealt with by the

National Commission, an analysis of the actual operations and continued competitive evolution of such facilities should serve as a valuable and necessary input to the Commission.

We believe, however, that the Subcommittee and the Congress could properly distinguish at the present time between the intrastate operation of such EFT facilities by insured financial institutions headquartered within that State and the possible interstate operation of such facilities by insured financial institutions. Most currently operated EFT facilities are in the former category, while possible interstate systems appear at this point in time to be only in various stages of early development. Few States have addressed themselves to this aspect of EFT development, and only a handful of banks or bank holding companies with "grandfather privileges" presently operate "retail" facilities or deposit-receiving branches outside their home States. On the other hand, the rulings of the Comptroller and the Federal Home Loan Bank Board may have the effect of giving federally chartered institutions a significant head start over their State-chartered competitors in the development of interstate EFT facilities which in due course the National Commission may recommend that the Congress limit or prohibit altogether. In this regard, these administrative rulings may result in a fundamental and basic change in the essentially local character of "retail" banking in the United States -- without benefit of any conscious study, analysis or approval by the Legislative Branch.

If, after review, the Congress were to decide that it did not wish to prohibit the interstate establishment and operation of EFT facilities altogether, there is a middle course which it might wish to consider. This would allow such interstate facilities only where the State of intended location has, by statute, explicitly authorized the establishment and operation of such facilities by an insured financial institution headquartered in another State. This would avoid the imposition of a Federal ban on interstate EFT activities that might well be permissible under explicit provisions of State law. Such State law provisions might, but need not, be limited to institutions headquartered in another State which had enacted reciprocal legislation authorizing insured financial institutions headquartered in the first State to establish similar facilities within its borders. Any remaining problems of competitive imbalance between State and federally chartered institutions headquartered in the same State could then be adjusted by changes in the State law in the headquarters State, just as they could be with respect to the intrastate facilities we recommend not be covered by a Federal moratorium.

The FDIC's position on Title II may thus be summarized as follows: We oppose the total moratorium on EFT facilities required by the present terms of the bill and would urge instead explicit Congressional guidance on whether or not such facilities constitute "branches" under present Federal law for purposes of applying the provisions of State law which might govern their location and approval. If this appears neither desirable nor feasible and the Congress believes <u>some</u> moratorium should

be enacted while it awaits the report of the National Commission or a judicial determination of the "branch" question, we recommend that the moratorium not apply to the establishment of such facilities intrastate but only to the establishment of such EFT facilities across State lines (unless, possibly, such facilities are affirmatively authorized by explicit statute in the State of intended location).

Should the Subcommittee desire the Corporation's technical assistance in drafting the legislative provisions on which it may ultimately decide, we stand ready to help at any time.

Disclosure of Mortgage Loan and Deposit Data

Title III of H. R. 8024 would require all banks and thrift institutions located in standard metroplitan statistical areas to compile certain data relating to residential and commercial real estate loans and to time and savings deposits. In accordance with regulations to be issued by the Secretary of Housing and Urban Development, this information would be made available to the public for inspection and copying at each office of the institution. The loan and deposit data would be required to be classified according to the particular census tract where the real property is located or where the depositor resides. If the property or depositor is located outside a standard metropolitan statistical area, the classification would be by county. The provisions of Title III would not apply to loans made or deposits received prior to the date of enactment of the Title. Compliance with Title III's requirements would be enforced by the Federal financial regulatory agencies with respect to institutions within

their direct jurisdiction, pursuant to their administrative enforcement authority under existing statutes.

While not so requiring, the bill would encourage real estate lending in certain geographic areas. In general, there is a legitimate question as to the extent, consistent with the protection of the bank's capital, that banks should be encouraged to make real estate loans in deteriorated neighborhoods. The blame for the degeneration of certain neighborhoods cannot be placed principally on the reluctance of financial institutions to invest in these neighborhoods. To do so is to ignore the realities of crime, poverty, delinquency, vandalism, and all the other social problems prevalent in today's world which cause declining market values. This is not meant in any way to condone discrimination based on race, color, religion, or national origin, but rather to emphasize that there are legitimate economic considerations which banks should be permitted to assess in the granting of real estate loans, particularly in declining neighborhoods.

The stated purpose of this legislation is to provide citizens and public officials with sufficient information to enable them to determine which depository institutions are fulfilling their obligations to serve the housing and business needs of the communities and neighborhoods in which they are located. It is far from certain, however, that the requirements of this Title would provide <u>sufficient</u> information to enable either citizens or public officials to adequately assess whether depository institutions are serving the needs of their communities. It would appear that, as a minimum, data relating to the demand for real estate loans in each neighborhood and data relating to rejected applications for real estate loans by neighborhood would be necessary to assess whether a depository institution is serving the needs of each neighborhood and the community.

While the information required by Title III is considered insufficient to fulfill its stated objectives, collection and recordkeeping of this information could be burdensome and time-consuming for many financial institutions. This would be particularly true for smaller banks which do not employ computer services.

There is one particular aspect of the recordkeeping requirements under Title III which appears unnecessarily burdensome to financial institutions. Under Section 304(a)(1), it appears that all information required to be compiled would have to be made available at each office of a depository institution. This would include detailed information regarding loans and deposits of the home office and all branch offices. The maintenance of a complete set of statistics at every office appears unnecessarily duplicative. It would appear more feasible for the home office to maintain a complete data file and each branch office to maintain only the information relative to its own operations or locality.

As a related matter, the FDIC in conjunction with the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Home Loan Bank Board undertook a Fair Housing Lending Practices Pilot Study in 18 standard metropolitan statistical areas throughout the United States for the period of June 1, 1974 through November 30, 1974. The purpose of the Pilot Study was to test the effectiveness of recordkeeping and reporting programs designed to enforce Title VIII of the Civil Rights Act of 1968. Three distinct data collection systems were utilized to determine which data were the most significant and which recordkeeping and reporting

procedures were the most effective. One aspect of the Pilot Study related to the determination of whether the use of census tracts or the use of zip codes would prove to be more informative regarding property location and type and composition of neighborhoods.

Since Title III would place an extensive recordkeeping burden on many depository institutions, we would prefer that action on this legislation be delayed until the information it would require can be evaluated in the light of the results and conclusions from the Pilot Study conducted last year by the four financial agencies. The results of this Pilot Study for six of the 18 metropolitan areas were released early last May by the Federal Reserve and the FDIC, and the results for an additional six metropolitan areas were released by the Comptroller of the Currency on July 14. Results for the final six metropolitan areas should be released by the Federal Home Loan Bank Board in the near future.

If your Subcommittee should nevertheless decide to report favorably with respect to Title III, we would strongly recommd that, in addition to the amendment to § 304(a)(1) suggested above, Title III should be amended to confine its scope to residential mortgage lending and to delete therefrom all references to commercial real estate loans as well as to time deposits and savings accounts. The assumption that construction lending or other loans on commercial real estate should be confined to the localities where a financial institution's head office or a branch thereof is located is not valid in our opinion. Likewise, the assumption that financial institutions have a duty to make mortgage loans in a locality in direct correlation to the amount of savings and time deposits received from such locality seems also to be a questionable one. Lending institutions have

an obligation to their depositors to exercise prudence and sound judgment in the investment of funds and cannot, consistent with this obligation, ignore factors affecting long-term values and loan security solely because of the amount or number of deposits received from a particular locality. In fact, if any such specific correlation between deposits and loans were to be required, the probable effect would be to afford a relative advantage to those institutions which make the least effort to provide savings facilities and other financial services convenient to customers residing in declining neighborhoods and, therefore, to discourage location of branches and similar facilities in such neighborhoods.

FDIC

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, D.C. 20429

OFFICE OF THE CHAIRMAN

July 18, 1975

Honorable Fernand J. St Germain
Chairman, Subcommittee on Financial
Institutions, Supervision, Regulation
and Insurance
Committee on Banking, Currency and Housing
House of Representatives
Washington, D. C. 20515

Dear Mr. Chairman:

This will respond to that portion of your June 27, 1975 letter which requests the Corporation's views on H. R. 2752, H. R. 1005 and H. R. 550, 94th Congress, bills designed to protect and preserve the confidential relationship between financial institutions and their customers.

H. R. 2752

H. R. 2752, the "Right to Financial Privacy Act of 1975," would prohibit Government agencies from obtaining customer records from banks, trust companies, savings and loan associations and credit unions and would likewise prohibit these financial institutions from disclosing customer records to Government agencies and officials, except when authorized by customer consent, administrative summons or subpoena, search warrant, or judicial subpoena. The bill lists the elements necesssary for each such exception. It would exempt from this prohibition information of a general nature that does not identify the customer, reports or returns required to be made under the Internal Revenue Code, and information disclosed to Government agencies which supervise financial institutions. The Secretary of the Treasury would be prohibited from requiring a financial institution to maintain financial records or transmit reports on customers unless necessary for bank supervision purposes or unless such records are required by the Internal Revenue Code. The bill would authorize the imposition of criminal and civil penalties (including nominal, actual and punitive damages) for violations of its provisions.

The Corporation is in general agreement with the stated purpose of H. R. 2752 to preserve the confidential relationship existing between financial institutions and their customers. We believe, however, that such purpose should be effected in a manner that will not seriously hamper the supervisory and enforcement functions of various Government agencies. In this connection, we urge that H. R. 2752 be amended and clarified in several respects as follows:

Section 5. This Section would prohibit a financial institution from disclosing a customer's financial records to a State or Federal agency, except under certain procedures with the customer's consent or pursuant to court order or a judicial or administrative subpoena. This prohibition would not prevent a financial institution from notifying law enforcement authorities of criminal violations suspected of being committed against the institution itself. Section 5 as presently drafted, however, could seriously impair certain Federal and State laws which require other disclosures to governmental authorities. For example, under the evolving aiding and abetting doctrine as regards violations of Federal securities laws, it is possible that a material misrepresentation in a customer's offering circular of his loan terms with a bank could impose upon the bank an affirmative duty to disclose the true situation. While Section 5 of the bill as presently drafted would not relieve the bank of any duty that might presently exist to disclose the situation to prospective purchasers of the customer's securities, the Section would prohibit the bank from making the same disclosure to the Securities and Exchange Commission. We recommend that Section 5(a) be amended to insure that the bill does not inadvertently relieve banks of any existing obligation under State or Federal law to make disclosures. (See Item 2 in attached Technical Amendments.)

The Committee might also want to consider amending Section 5 to prohibit a financial institution's disclosure of customer records to any person, Government employee or otherwise. We see no reason for limiting the scope of such prohibition to Government agencies.

Section 8. This Section would permit State and Federal agencies to examine a customer's records at a financial institution pursuant to a search warrant, but only after the warrant had been served on the customer, as well as the financial institution. Since constitutional requirements would seem to be satisfied by the ex parte hearing held prior to issuance of the search warrant for the purpose of establishing probable cause, we would recommend against departing from the usual procedures which are followed in connection with search warrants. Alerting the customer that an investigation is in process could well afford him an opportunity to frustrate successful prosecution by concealing or destroying evidence. We therefore urge that Section 8 be revised accordingly.

Section 10. This Section would prohibit a governmental agency from providing to another agency copies of information it had obtained pursuant to customer authorization, a search warrant, or an administrative or judicial subpoena.

On the other hand, the Section would not prohibit a supervisory agency from disclosing financial information it has obtained in accordance with Section 11(b) in the course of its supervisory function. We recommend that Section 10 be amended to extend the prohibition against disclosure to information obtained in accordance with Section 11(b). (See Item 5A in attached Technical Amendments.)

If Section 10 is so amended, the Corporation and other supervisory agencies would then be prohibited from disclosing to appropriate enforcement authorities information indicating a violation of law which they had discovered in the course of their supervisory activities. Therefore, it would become essential to adopt a further amendment to Section 10 permitting such disclosure to appropriate law enforcement agencies. Even if Section 10 is not amended as recommended in the previous paragraph, we believe this second amendment to Section 10 should be adopted to make abundantly clear that the Section is not intended to prevent disclosure of violations of law to enforcement authorities. (See Item 5B in attached Technical Amendments.)

Section 11. This Section would exempt examinations by and disclosures to supervisory agencies of financial records used in the exercise of the agencies' "supervisory function[s]" from many of the limitations on disclosure in the bill. While the language "supervisory function" would clearly exempt the Corporation insofar as its bank regulatory functions are concerned, it is not altogether clear that this language would exempt the Corporation in the execution of its insurance and liquidation functions. Since we are certain the bill is not intended to inhibit the Corporation in carrying out these latter functions, we strongly recommend that Section 11(b) be appropriately amended. (See Item 6 in attached Technical Amendments.)

H. R. 1005

The only substantive differences between H. R. 1005 and H. R. 2752 are as follows:

(1) H. R. 1005 would delete from the bill all references to State and local governments (§§ 5(a) and (b), 7(a), 8, 9, 14(a) and 15(a) and (b)), thus exempting all disclosures by banks of confidential customer information to State and local governmental officers and employees, regardless of the use to be made of such disclosures. As indicated in our comments above on § 5 of H. R. 2752, we would instead recommend expanding the bill's coverage to include disclosures to any person, governmental employees or otherwise, unless the disclosures fall within one of the explicit exemptions provided in the bill.

(2) H. R. 1005 would delete the words "access to" in § 5(a) of the bill, thus apparently permitting Government officials to look at (but not to obtain copies of) confidential customer information in the files of financial institutions. We would suggest keeping these words in the bill so as to restrict such access, unless full disclosure to such officials is within the explicit exemptions provided in the bill.

(3) H. R. 1005 would delete the words "against the financial institution itself" in § 5(b), thus permitting financial institutions to notify law enforcement officials of suspected criminal law violations whether or not committed against the financial institution itself. We support this change. See our comments above on § 5 of H. R. 2752.

(4) H. R. 2752 provides in § 6(a)(1) that a customer's written authorization to divulge his financial records is valid for one year.

H. R. 1005 would shorten this period to three months. We would support the shorter three-month period in H. R. 1005.

(5) H. R. 1005 has an apparent typographical error in § 12(1): The "and" at the end of clause (1) should read "or" as in H. R. 2752.

(6) H. R. 1005 omits §§ 18 and 19 relating, respectively, to inconsistent provisions of law and separability. We believe both such sections should be retained.

H. R. 550

This bill is generally similar in substance to H. R. 2752 and H. R. 1005. The major differences are described below:

(1) By way of technical comments, H. R. 550 uses the term "fiduciary institutions" in lieu of the term "financial institutions" as used in H. R. 2752 and H. R. 1005. We would suggest that the term "financial institutions" is perhaps more descriptive of the types of institutions covered by this proposed legislation.

(2) The definition of "financial records" in Section 2(a)(2) of H. R. 550 is longer but probably considerably narrower in scope than the definition utilized in H. R. 2752 and H. R. 1005. We prefer the definition in the latter two bills because of its broader and more descriptive terminology; viz., "any record held by a financial

institution containing information pertaining to a customer's relationship with the financial institution." See comment 1-B in the attached Technical Amendments to H. R. 2752.

(3) Section 3 of H. R. 550 is of broader applicability than comparable provisions in H. R. 2752 and H. R. 1005, in that H. R. 550 would cover disclosure by a financial institution of confidential customer information to any person (not limited to disclosures to governmental employees as provided in the other two bills). We prefer the broader applicability of this proposed legislation, as discussed in our comments above on § 5 of H. R. 2752.

(4) Section 4(1) of H. R. 550 would limit the validity of a customer's written authorization to disclose his financial records to one week, as opposed to three months in H. R. 1005 and one year in H. R. 2752. We believe the one-week period is too short and would prefer the three-month period specified in H. R. 1005. Also, H. R. 550 does not contain any provisions comparable to those in H. R. 2752 and H. R. 1005 which would prevent financial institutions from requiring written authorizations to disclose financial records as a condition of doing business with the institution (see Section 6(b) of H. R. 2752) and which would require the financial institutions to keep records of access to a customer's financial records and make such access records available to the customer (see Section 6(c) of H. R. 2752). We would prefer to see these types of provisions incorporated in this proposed legislation.

(5) Section 5 of H. R. 550 permits access to financial records only pursuant to a court order based on probable cause sufficient to support issuance of a valid search warrant and after service of the court order on the customer. In our opinion, this provision is too narrow in that it does not permit access to such records pursuant to administrative subpoenas and summonses permitted under § 7 of H. R. 2752. Moreover, in requiring notice to the customer before the records are furnished pursuant to the court order, we believe the bill would give the fraudulent or dishonest customer a chance to abscond or destroy evidence and thus frustrate legitimate law enforcement efforts in certain circumstances. See our comments above on § 8 of H. R. 2752.

(6) Section 6(2) would permit the Secretary of the Treasury to continue to require financial institutions to keep certain financial records relating solely to international financial transactions. We would support incorporating this type of authorization in the proposed legislation.

(7) H. R. 550 does not include any provision relating to injunctive relief, waiver of rights, inconsistent provision of law, separability or effective date comparable to §§ 16-20 of H. R. 2752. We would support including such provisions in this type of legislation.

In conclusion, the FDIC would support legislation along the lines of H. R. 2752 if it is amended as suggested above in our comments on that bill and as suggested in Items 3 and 4 of our comments on H. R. 1005 and in Item 6 of our comments on H. R. 550. Attached for your Subcommitte's consideration are suggested amendments to H. R. 2752, prepared by the Corporation's Legal Division, which would implement the above recommendations and make certain other changes essentially of a technical nature.

Sincerely,

Frank Wille

Frank Wille
Chairman

Attachment

TECHNICAL AMENDMENTS TO H. R. 2752

(Prepared in Legal Division, Federal Deposit Insurance Corporation)

1. Section 3. We recommend several amendments to this Section.

   A. The Subcommittee might want to expand the term "financial institution" to include any such institution having a place of business in any State or territory of the United States, including specifically all locations outside of the United States that are specified in the definition of "branch" in Section 3(o) of the Federal Deposit Insurance Act (12 U.S.C. 1813(o)); viz., Puerto Rico, Guam, American Samoa and the Virgin Islands. This amendment would insure that the protections afforded by the bill applied to all bank customers dealing with financial institutions operating from offices within the jurisdiction of the United States. The amendment would also have the effect of including in the bill financial institutions of foreign incorporation which have a place of business within the jurisdiction of the United States.

   B. Subsection (b)(1) seems to be included in (b)(2) and is therefore unnecessary.

Following is a suggested revision of Section 3 incorporating the above recommendations and certain minor technical changes:

"Sec. 3. For the purposes of this Act --

(a) The term "financial institution" means any bank, trust company, savings and loan association, credit union, or similar financial institution having a place of business in any State or territory of the United States, the District of Columbia, Puerto Rico, Guam, American Samoa, or the Virgin Islands.

(b) The term "financial records" means any original or any copy of any record held by a financial institution containing information pertaining to a customer's relationship with the financial institution.

(c) The term "person" means an individual, partnership, corporation, association, trust, or any other legal entity.

(d) The term "customer" means any person utilizing any service of an office of a financial institution located in any State or territory of the United States, the District of Columbia, Puerto Rico, Guam, American Samoa, or the Virgin Islands.

(e) With respect to any particular financial institution, the term "supervisory agency" means any of the following which has statutory authority to examine the financial condition of that institution --

(1) the Federal Deposit Insurance Corporation;

(2) the Federal Savings and Loan Insurance Corporation;

(3) the Federal Home Loan Bank Board;

(4) the National Credit Union Administration;

(5) the Board of Governors of the Federal Reserve System or any Federal Reserve Bank;

(6) the Comptroller of the Currency; or

(7) any State banking department or similar agency."

2. Section 5. We recommend that subsection (a) be amended by adding the following language thereto: "Provided, however, That nothing in this Section shall negate or limit any duty to disclose imposed by applicable State or Federal law."

3. Section 6. Subsection (c) should be amended to make clear that the requirement of recordkeeping refers only to examinations authorized under Section 6. The references to "examinations" in that subsection should be changed to refer to "access" so as to include other methods of receiving the information contained in the records. Finally, the last sentence in subsection (c) should be amended to specify when the financial institution would be required to notify the customer that he had a right to revoke his authorization.

4. Section 7. We see no reason for the distinction made in the bill between administrative summons or subpoenas and judicial subpoenas, as both essentially would, under the bill as presently drafted, require a court order before the financial institution may comply. We would therefore

combine both types of subpoenas in one section, and would incorporate the less onerous requirement of Section 9 that a subpoena would become final unless the customer moves to quash the subpoena within 10 days after receipt. Since the underlying rationale behind the stringent court order provision of Section 7 seems to be intended to insure that the customer is actually notified and has an opportunity to challenge the subpoena, we would recommend that the combined new section specifically require notification of the customer by a person not an interested party, such as the financial institution itself.

Following is a recommended Section, combining Sections 7 and 9:

"(a) an officer, employee or agent of the United States or any department or agency thereof or of a State or local government may obtain financial records under Section 4(a)(2) pursuant to an administrative subpoena or summons or a judicial subpoena otherwise authorized by law only if:

(1) The subpoena or summons includes the name of the customer and the purpose for which the information is to be obtained; and

(2) The financial institution notifies the customer, as required by subsection (b) of this Section; and

(3) Ten days pass from the date of mailing of such notification without the notice to the financial institution that the customer has moved to quash the subpoena or summons; or where the financial institution has been notified that the customer has moved within the 10-day period to quash the subpoena or summons, the financial institution is either served with a court order directing it to comply, issued after determination of the customer's motion, or it is satisfied that the customer has not in fact so moved.

"(b) Any financial institution served with a subpoena or summons of the type described in subsection (a) shall promptly notify the customer of such service by mail to his last known address. Such notice shall advise the customer that the financial institution is required to comply with the subpoena or summons within 10 days after the date such notice is mailed unless the customer takes legal action to quash the subpoena or summons."

5. Section 10.

A. We recommend that the following be inserted in this Section immediately before the word "be" in Line 24.

", or information or records obtained by a supervisory agency under the exception specified in Section 11(b),"

B. We recommend that the following be added to Section 10:

"Provided, however, That any supervisory agency receiving information in the course of discharging its statutory functions which in its judgment tends substantially to indicate a violation of law by any financial institution which it regularly examines, or by any director, officer, employee, agent or representative thereof, may release such information to any governmental entity charged with enforcing such law."

6. Section 11. We recommend the revision of subsection (b) as shown below:

(Underlining indicates additions and brackets indicate deletions.)

"(b) Subject to the limitations in Section 10, nothing in this title prohibits the examination [by or disclosure to any supervisory agency] of financial records [solely in the exercise of its supervisory function] by, or the disclosure of such records to, any supervisory agency, or any officer, employee or agent thereof, acting in accordance with applicable laws, and nothing in this title prohibits [or] the making of reports or returns required under the Internal Revenue Code of 1954."

FDIC NEWS RELEASE

Statement on

Current Status of United States National Bank
and Franklin National Bank Receiverships.

Presented to the

Subcommittee on Financial Institutions,
Supervision, Regulation and Insurance
Committee on Banking, Currency and Housing
House of Representatives

by

Frank Wille, Chairman
Federal Deposit Insurance Corporation

July 21, 1975

This statement further supplements FDIC's reports to Congress of year-end 1973 and 1974 on the status of the receivership of the United States National Bank, San Diego, California ("USNB") and the reports on the Franklin National Bank, New York ("Franklin") receivership which FDIC has issued at least quarterly since Franklin's failure. Copies of these reports are attached. The dates supplied in this update reflect the positions of the USNB and Franklin receiverships on June 30 of this year.

Franklin National Bank

As a result of the competitive bidding which followed the Comptroller of the Currency's closing of Franklin on October 8, 1974, the European-American Bank and Trust Company agreed to purchase certain of Franklin's assets and to assume $1.6 billion of its liabilities, including all of its deposit liabilities. European-American has now selected substantially all of the approximately $1.49 billion in assets it agreed to select under the October 8, 1974 Agreement with FDIC. This selection is expected to be completed by the end of this month.

Total FDIC collections with respect to the Franklin assets being liquidated by the Corporation had increased to approximately $394 million as of June 30. This figure includes the collection of principal and interest on loans made by Franklin, the receipt of interest on securities and other assets of Franklin and the sale of some assets, including the sale of the foreign subsidiary of Franklin's Edge Act subsidiary. In addition, FDIC has initiated an orderly liquidation of Franklin's securities, an undertaking which may last for a number of years.

Payments from these collections in the aggregate amount of over $347 million have been made by FDIC to the Federal Reserve Bank of New York and have reduced the principal amount due on Franklin's "window" loan on the day it closed from $1.723 billion to $1.376 billion. (Interest on the loan will not be due until October 8, 1977). Under prevailing market conditions, the Corporation plans to continue paying the Federal Reserve Bank of New York amounts collected in its liquidation efforts over and above the amount required to maintain a sufficient working balance.

Expenses of the liquidation through June 30, 1975 amounted to approximately $4.8 million. This figure includes FDIC's liquidation staff in New York City of 115 individuals and legal counsel both within and outside the United States.

When Franklin closed, many persons who depended upon it to meet their credit needs were left without credit facilities.*/ While a substantial

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*/ As receiver for a national bank, FDIC is limited in its ability to provide ongoing financing for many of the bank's former customers. FDIC cannot simply continue to make loans. The most FDIC may do is to make advances to former customers of the bank where it finds that such action is necessary to protect existing receivership assets (12 C.F.R. 306.1 and 306.2).

In a related development, the Corporation is a defendant in a recent action filed by a Long Island builder who had been a substantial borrower from Franklin. The suit alleges in part that substantial damages were sustained because of the Corporation's failure to provide the plaintiff with additional financing in connection with the completion of a partially constructed office building. The request for continued financing was rejected by FDIC's Board after due consideration because it could not make the required finding.

percentage of such persons have been able to make substitute banking arrangements, others have not. To remedy this situation, FDIC has initiated a program for bringing together borrowers and financial institutions or intermediaries capable of providing continued financing. FDIC's contact at this point has been with the commercial banks in the Long Island Bankers Association and the mutual savings banks located in the Greater New York area. Future efforts of a similar nature with other financial institutions can be expected.

FDIC succeeded to Franklin's positions in several hundred pending lawsuits upon its appointment as receiver. Most of these actions involved collection matters. Among the more significant of the litigation matters, however, were five purported class actions seeking damages on behalf of purchasers of securities issued by Franklin's parent, the Franklin New York Corporation, and four derivative suits claiming damages on behalf of the holding company's stockholders. These suits have all now been transferred to the United States District Court for the Eastern District of New York for coordinated or consolidated pretrial proceedings.

Recent developments in another lawsuit are worth mentioning at this time. Following the October 8, 1974 closing of Franklin, the plaintiff in a major lawsuit which was pending against Franklin filed motions to join FDIC and European-American in the suit as additional defendants. The plaintiff asserted, among other things, that the purchase and assumption transaction stripped the receivership estate of any assets from which payment could be

made to contingent creditors of Franklin and that either the Corporation or European-American had assumed Franklin's liabilities. The court held in effect that consideration of any action against the Corporation and European-American was premature until after plaintiff's claim had been successfully proved against Franklin and after all the liabilities of the receivership estate had been determined.

The November 23, 1974 report on Franklin discussed in some detail the pre-closing problem of Franklin's foreign exchange exposure. Briefly summarized, in order to protect the international financial markets the Federal Reserve Bank of New York ultimately agreed to assume Franklin's foreign exchange position in exchange for Franklin's deposit, net of confirmation risk, of approximately $9.7 million, to cover possible losses and Franklin's agreement to make up any additional shortfall. I am pleased to report that based upon the handling of Franklin's foreign exchange contracts by the Federal Reserve Bank of New York, no additional loss to the receivership from this source is anticipated. In fact, the Corporation may ultimately recover approximately $6.7 million of the funds Franklin deposited with the Federal Reserve Bank of New York if a recently negotiated tentative settlement agreement with the parent company of a foreign corporation, which had been principally controlled by Sindona interests, is finalized. *

Finally, I should like to report on two additional recent developments. First, the problem which had existed with respect to certain domestic branches which had been financed by Franklin under special trust agreements has been resolved. European-American has now selected all 33 of these

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*For an update on the status of the USNB letter of credit litigation, see letter dated July 25, 1975 to Richard Still, Staff Director from Edward Bransilver, General Counsel, FDIC, at the conclusion of Chairman Wille's prepared statement.

branches at their aggregate appraised value of $18 million free and clear of any encumbrances.

Second, the bidding papers between FDIC and each bidding bank allowed the successful bidder to call upon FDIC for total capital support of a maximum of $150 million to be funded by FDIC. European-American has previously received FDIC capital note assistance in the amount of $100 million. We recently learned that European-American has decided not to exercise its option with respect to the additional $50 million.

It is still premature to make any precise estimate of the total recovery likely to be realized on the Franklin assets being administered by the Corporation. Most of these assets have not yet been appraised, and the task of marshalling the records on the approximately six thousand assets being administered by the Corporation has not been concluded. It seems likely at this time that the first reasonably accurate estimates of ultimate recoveries from all Franklin assets acquired by the Corporation will not be made until the latter part of the year. Of course, any estimates made even then will be subject to change as the liquidation progresses.

United States National Bank

In this second supplemental report on the status of the USNB receivership, I will just briefly give you an update on some of the more significant statistics relating to the receivership and then turn to recent developments in litigation arising out of the USNB closing.

Total collections on the receivership assets now amount to $36.4 million. The receivership estate has repaid approximately $25 million from these collections to the Federal deposit insurance fund, reducing the amount the receivership owes the fund to under $297 million.

The receivership has incurred total expenses of $2.7 million. Projecting the remaining life of our liquidation in San Diego at 9 years, we estimate future expenses to reach a total of $6.6 million, representing legal fees of $4.5 million, salary costs of $1.6 million and other expenses of $.5 million.

In my testimony on the USNB receivership before this Subcommittee last December, I stated that certain events, including FDIC's payment of some $47.7 million in disputed letter of credit claims, had caused FDIC's Board of Directors to anticipate adding substantially to the $48.3 million reserve for loss in regard to the receivership. I reported to the Subcommittee that our best estimate at that time was for an addition to the reserve of $50 to $100 million. Unfortunately, the larger amount of our estimation subsequently appeared to be needed. As a result, due in part to a substantial disparity between the book value and currently appraised value of certain assets held by the receivership, we have now established the reserve for loss at $150 million. This reserve in turn may fluctuate in the future depending upon the Receiver's success in liquidating the remaining assets and in defending and pursuing litigation involving the receivership estate.

Turning to litigation matters, the major litigation affecting the USNB receivership has increased in both volume and scope since my last report to the Subcommittee on December 12, 1974. This litigation primarily involves, as plaintiffs or defendants, certain persons affiliated with or related to USNB's controlling shareholder, C. Arnholt Smith. In addition, there has been increased activity in the cases involving USNB's letters of credit as the result of a decision by the Ninth Circuit Court of Appeals in the case of International Westminster v. FDIC.

As you may recall, the Purchase and Assumption Agreement between the Receiver of USNB and Crocker did not provide for the transfer to Crocker of liabilities and assets of persons or entities which appeared to be controlled by or in close association with C. Arnholt Smith. Pursuant to its statutory duty to collect all the assets of the receivership, the Receiver has filed thirteen separate lawsuits against some thirty-five members of this group seeking recovery of nearly $100 million in compensatory damages and over $40 million in punitive damages. Most of these actions seek recovery on presently unpaid promissory notes. Named as defendants in these actions are all of those parties which appear to have participated in and benefited from the diversions of United States National Bank funds to entities other than those which appear as obligors on the notes. However, the present capacity of many such persons to repay the funds in the event of favorable court decisions is, at best, doubtful.

Although C. Arnholt Smith is named as defendant in five such actions brought by the Receiver, one suit which was filed against Smith as a sole defendant is of particular interest. This lawsuit seeks to recover approximately $45 million under a personal indemnity given by Mr. Smith to USNB pursuant to a Cease and Desist Order issued by the Comptroller of the Currency in May of 1973. The Comptroller's Order required Mr. Smith to indemnify the bank against any losses resulting from many of the loans, extensions of credit or guarantees in favor of the group affiliated with or related to him. Smith has just filed an answer admitting the basic facts surrounding the execution of the Indemnity Agreement, contending, however, that the loans upon which the action is based are not 'losses,' that the Receiver has not taken the necessary steps to collect the obligations, that the Comptroller of the Currency forced him to sign the agreement under duress and that he was induced to sign the agreement by the Comptroller's promise not to close the bank. These allegations have not yet been answered by the Receiver.

The Receiver is at the same time defending various actions brought by certain Smith-related persons or entities. The reorganization trustee for the Westgate-California Corporation ("Westgate") has filed a suit in the Federal District Court for the Southern District of California which seeks to recover $1.5 billion in actual and punitive damages from some 180 defendants. In addition to the Receiver, some of those named as defendants in this action are Mr. C. Arnholt Smith, former directors of USNB, and many members of the Smith-related group. The Westgate suit alleges several years of self-serving

domination by Mr. Smith and his associates and seeks recovery for securities fraud and other alleged wrongs. The reorganization trustee for Westgate has also filed a petition in the U.S. Court of Claims against the United States whereby it seeks to recover $100 million for an alleged unconstitutional taking of Westgate property by various agencies of the Federal Government. The petition alleges that the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Reserve Bank of San Francisco, and the FDIC undertook a course of regulatory activity which had the effect of strengthening the United States National Bank and protecting the Corporation's insurance fund at the expense of Westgate and its subsidiaries. In addition, the reorganization trustee for Westgate and M. J. Coen, another person closely related to Mr. Smith, have each filed administrative claims for damages pursuant to the Federal Tort Claims Act based upon various injuries allegedly caused by wrongful regulatory activities by the four above-mentioned agencies. The Receiver has filed an application with the Chapter X Reorganization Court for an order requiring the trustees to dismiss all three of these actions on the basis that the claims are without merit, the continuation of the actions will deplete the assets of the debtor estate, and that the trustees have not filed required reports with the court demonstrating the benefits of such action and obtained leave of court to commence them.

Finally, yet another person closely related to Mr. Smith, Hollis Roberts, has filed suit against the Comptroller of the Currency, the Corporation, USNB, Mr. Smith and others seeking approximately $27 million compensatory and punitive damages for alleged wrongs.

The lawsuits involving the still outstanding letters of credit issued by USNB are still pending and since my last report to this Subcommittee, there has been significant activity in these cases. In January of this year, the Court of Appeals for the Ninth Circuit in the case of International Westminster v. FDIC reversed and remanded the case to the trial court in order to allow the plaintiffs to file amended pleadings. The decision of the court of appeals did not disturb the rulings of law which had been made by the trial court. Shortly thereafter, amended pleadings were filed by the plaintiffs in these actions. Plaintiff's motion for summary judgment in one of the cases was recently denied, causing plaintiffs in the other cases to withdraw similar motions. All cases are now in the pre-trial discovery stage in the Southern District of California.

The letter of credit cases represent some of the most significant litigation in FDIC's history. They involve far more than the $47 million in losses claimed by the plaintiffs. At issue is FDIC's statutory authority and flexibility to divide a large complex bank into its "good" and "bad" parts for the purpose of salvaging those "good" parts necessary to insure needed and continued banking services in the community. Such flexibility is needed in order to avoid, in appropriate cases, the necessity for handling a large bank closing by merely paying off its insured deposits and liquidating the entire bank.

Finally, the Subcommittee is no doubt aware that all criminal action against C. Arnholt Smith and Philip A. Toft was dropped when both parties

settled their criminal liability with no contest pleas. Messrs. Smith and Toft were each fined and each received a suspended jail sentence.

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, D.C. 20429

OFFICE OF THE GENERAL COUNSEL

July 25, 1975

Mr. Richard Still, Staff Director
Subcommittee on Financial Institutions,
Supervision, Regulation & Insurance
Committee on Banking, Currency & Housing
House of Representatives
Washington, D.C. 20515

Dear Dick,

You asked Ted Reardon for amplification of certain portions of Chairman Wille's statement before your Subcommittee on July 21. In accordance with our telephone conversation in respect thereof, I submit the following.

On page 4 of the statement there is an update on the status of the USNB letter of credit litigation. In International Westminster v. FDIC and other similar letter of credit lawsuits, the plaintiff banks which held USNB's letters of credit at the time of its insolvency are arguing that (1) they were creditors of USNB on the date of its insolvency; (2) they consequently have provable claims on USNB's receivership estate administered by FDIC; (3) FDIC violated the provisions of the National Bank Act (specifically Sections 91 and 194 of Title 12, United States Code) by failing to distribute the assets of USNB in a ratable manner to all of the bank's creditors, including claimants, since their letters of credit were not assumed by Crocker National Bank under the October 18, 1973 Purchase and Assumption Agreement; and (4) the security interest FDIC took in the remaining assets of USNB constituted an illegal preference.

In response to the plaintiffs' arguments, FDIC contends, among other things, that (1) the plaintiff banks are not creditors with provable claims on the receivership since their claims were subject to certain legal deficiences on the date of USNB's insolvency; (2) 12 U.S.C. § 91 has no applicability to a closed bank; (3) a sale of assets by FDIC as receiver pursuant to § 13(e) of the Federal Deposit Insurance Act (12 U.S.C. 1823(e)) does not in any event constitute a "dividend" under 12 U.S.C. § 194; (4) even assuming plaintiffs' letters of credit constitute provable claims on the USNB receivership, FDIC is nonetheless vested with discretionary authority under Section 13(e) of its Act, so long as it acts reasonably, to arrange a purchase and assumption-type transaction which sells only a portion of a closed bank and which necessarily results in some liabilities, as well as assets, remaining in the receivership; and (5) FDIC's security interest in the assets in the receivership is authorized, if not required, by statute. Further, FDIC asserts certain defenses available to it by virtue of its status as a Federal agency.

Attached are press releases, dated June 19, July 2, and July 3, 1974, relating to FDIC's payment of certain letter of credit liabilities through Crocker National

BEST COPY AVAILABLE

Bank pursuant to the October 18, 1973 Purchase and Assumption Agreement. Press Release 39-74, dated July 2, 1974, contains a list of USNB letters of credit which were initially not assumed by Crocker and, following FDIC's investigation, were (1) assumed by Crocker and thus paid to the banking beneficiaries; (2) not assumed by Crocker pursuant to the aforesaid agreement; or (3) cancelled prior to USNB's insolvency.

On page 3 of the statement there is a reference to a recently negotiated tentative settlement agreement arising out of Franklin's foreign exchange activity. A copy of that agreement is enclosed, together with a copy of a letter dated April 16, 1975 from Chairman Wille to Attorney General Levi, the latter portion of which describes the action which would be settled by this agreement. The date for execution of definitive documents has been extended to July 31.

If you need any further information on these items, please let me know.

Sincerely,

Edward Bransilver
General Counsel

Enclosures

FDIC
FEDERAL DEPOSIT INSURANCE CORPORATION

NEWS RELEASE

FDIC CLASSIFIES $45 MILLION OF DISPUTED LETTERS OF CREDIT ISSUED BY UNITED STATES NATIONAL BANK, SAN DIEGO, AS INTERBANK LOANS OR DEPOSITS AND ARRANGES FOR IMMEDIATE PAYMENT

Chairman Frank Wille announced today that the Board of Directors of the Federal Deposit Insurance Corporation, acting as Receiver for the United States National Bank (USNB), has completed its review of the facts now available to it surrounding the issuance by USNB of each of 57 standby letters of credit and has determined that 35 of such letters, totalling approximately $45 million plus interest, represent direct interbank loans or deposits of that bank and can be paid immediately. Holders of these obligations are being notified individually of the FDIC's action and will be paid as soon as proper documentation is presented to Crocker National Bank. As Receiver, FDIC will advance to Crocker the funds necessary for these payments under the terms of the Purchase and Assumption Agreement which it entered into with Crocker on October 18, 1973.

In the case of the other 22 letters of credit reviewed, which total slightly over $41 million in principal amount, the FDIC Board of Directors determined that the letters of credit were properly booked by USNB as contingent liabilities for which the account party named in the letter of credit is primarily liable. Claims based on such letters of credit are being retained as possible claims against the USNB receivership estate, the amount of which will depend on collections directly from the account party or from the proceeds of collateral which in some cases secures certain of these letters of credit.

Ten of these retained letters of credit, for example, totalling almost $13 million in principal amount, are expected to be cancelled within the next week to 10 days as the result of the sale of collateral securing the underlying obligation of the account parties named. The FDIC is urging holders of the other standby letters of credit retained in the USNB receivership to collect from, or refinance their loans with, the account party to whom they loaned the amounts specified in the letters of credit they hold.

All holders of USNB letters of credit in this second category are also being notified individually by the FDIC as to the reasons why the FDIC Board of Directors views the transaction on which the letter of credit is based as a direct loan to a third party on which USNB is only contingently liable.

The standby letters of credit reviewed to date by the FDIC Board of Directors aggregate approximately $86 million of the $91.3 million outstanding on the day USNB was declared insolvent, which USNB had booked as contingent liabilities on

loans made directly by the holders of such letters to business entities affiliated with or closely related to USNB's former chairman and controlling shareholder, Mr. C. Arnholt Smith. In addition, five letters of credit totalling approximately $1 million were cancelled by USNB prior to closing or satisfied by set-off since October 18, 1973. The $4 million in principal amount of standby letters of credit not covered by today's announcement include letters of credit on which the holder has as yet incurred no liability, claims have not been filed, additional information is being requested, or the review process has not been completed.

Prior to its closing by the Comptroller of the Currency last October, USNB's records indicated that it had outstanding approximately $91.3 million in letters of credit which were carried on its records as standby letters of credit issued to guarantee the obligations of account parties affiliated with or closely related to Mr. C. Arnholt Smith. The FDIC determined to retain these obligations in the receivership because, among other things, the loans underlying the letters of credit (as with the other Designated Group loans retained in the receivership), were of questionable quality and were not acceptable to the potential purchasers of USNB without FDIC either providing the cash to cover them or fully guaranteeing their collectibility. Also, there was a serious legal question as to the obligation of the Receiver to pay a liability which had not arisen before the closing of the bank. Finally, FDIC was uncertain as to whether all such standby letters of credit were actually reflected on USNB's records.

Shortly after USNB was closed a number of holders of the standby letters of credit retained in the receivership advised FDIC that the obligations they held were not USNB guarantees of customer loans, but rather evidence of the holders' direct deposits in or loans to USNB. They claimed that they had not made loans to C. Arnholt Smith-related or affiliated customers, had not purchased any loans of those persons from USNB and had no relationship with or knowledge of such Smith-related or affiliated persons. Thereupon, FDIC asked each of the holders of the letters of credit to file a proof of claim outlining its version of the transaction. All but a few of the holders of these letters of credit filed very detailed claims describing their transactions with USNB.

FDIC also launched an extensive investigation of its own to determine, to the extent possible, the facts underlying those transactions. In this regard, FDIC obtained bank records which were located off the bank's premises and in the private offices of Mr. C. Arnholt Smith. These records were found during a search of these premises by the Federal Bureau of Investigation and were made available to FDIC by the U. S. Attorney's Office in San Diego. FDIC Subpoenaed additional records from various brokers who had assisted USNB in placing these letters of credit and interviewed the brokers and a number of former officers and employees of USNB. FDIC also examined relevant files of the account parties named in the letters of credit. The two former officers of USNB with the greatest knowledge of these transactions, however, i.e., Mr. C. Arnholt Smith and Mr. Louis X. Sheid, the former officer of USNB in charge of its international department, refused to provide FDIC with information on the grounds that such information might be self-incriminating.

The transfer of USNB's assets and liabilities to Crocker on October 18, 1973 was based upon information then available to FDIC. Information regarding the letters of credit was obtained from the books and records of USNB and from a number of

senior USNB officials other than Mr. Smith and Mr. Sheid prior to October 18. Because of questions regarding the veracity of the information supplied by USNB and of USNB's records, the Purchase and Assumption Agreement with Crocker permitted the subsequent transfer to Crocker of USNB assets or liabilities later determined to have been erroneously retained by the receivership. Today's announcement is the result of FDIC's subsequent investigation. In effect, the FDIC Board has determined that the letter of credit obligations today transferred to Crocker were in fact direct interbank transactions rather than standby letter of credit transactions as reflected on USNB's books prior to October 18. By arranging for the transfer of these liabilities to Crocker and for the transfer from FDIC of the cash necessary to cover these liabilities, FDIC is fulfilling its obligation under the Purchase and Assumption Agreement to correct any errors or omissions in the liabilities assumed by Crocker which were discovered after the bank's closing.

In reviewing the claims filed with it and in its action taken today, FDIC sought to treat the holders of these letters of credit in the same manner that they would have been treated under the Purchase and Assumption Agreement with Crocker had FDIC known all of the relevant facts at the time the bank was closed last October. Thus the holders of the letters of credit, who, based upon the evidence gathered, lent money directly to USNB rather than to another entity are being paid the full amount of that loan including interest to the date of maturity of the letter of credit or its earlier payment, despite the fact that USNB improperly recorded these obligations on its books.

Chairman Wille further announced the Board's intention in due course to report in greater detail on its review and findings with respect to these USNB letters of credit to the appropriate committees of the Congress.

FDIC
FEDERAL DEPOSIT INSURANCE CORPORATION

NEWS RELEASE

FDIC CLASSIFIES ADDITIONAL $2 MILLION OF DISPUTED LETTERS OF CREDIT ISSUED BY UNITED STATES NATIONAL BANK, SAN DIEGO, AS INTERBANK LOANS OR DEPOSITS AND RELEASES DETAILS OF PRESENT STATUS OF ALL LETTER OF CREDIT CLAIMS REVIEWED TO DATE

Chairman Frank Wille announced today that the Board of Directors of the Federal Deposit Insurance Corporation, acting as Receiver for the United States National Bank (USNB), has completed its review of the facts surrounding the issuance by USNB of two additional standby letters of credit and has determined that each of the letters, totalling approximately $2 million, evidenced direct interbank loans or deposits of USNB. The Board's action brings to 37 the number of such standby letters of credit so classified, with a total principal amount of approximately $47.7 million. As Receiver, FDIC has advanced to Crocker National Bank under the terms of the Purchase and Assumption Agreement it entered into with Crocker on October 18, 1973, the funds necessary to pay each such letter of credit. As of the close of business Monday, July 1, 1974, 31 such letters of credit had been presented to Crocker and paid, leaving 6 unpaid with an aggregate principal amount of approximately $7.4 million.

The Federal Deposit Insurance Corporation also released today the details of its action with regard to the 59 standby letters of credit reviewed to date by the Corporation's Board of Directors. The attached tables list the holders of the 37 letters of credit assumed by Crocker National Bank under the aforesaid agreement, the country in which the holder is domiciled, and the status of payment of the letter of credit as of the close of business Monday, July 1, 1974. In addition, the attached schedule lists the holders of the 22 letters of credit reviewed by the FDIC Board of Directors which were determined to have been properly booked by USNB as contingent liabilities for which the account named is primarily liable. As Chairman Wille indicated in the FDIC's press release of June 19, claims based on these 22 letters of credit have been retained as possible claims against the USNB receivership estate. Two of these retained letters of credit, totalling $7.9 million in principal amount, have already been cancelled in connection with the sale of the Westgate Plaza Hotel in San Diego, the letters constituting additional collateral for repayment of a direct loan to the hotel which was secured by a first deed of trust on the premises, the latter having been satisfied prior to the closing. It is also anticipated that the letters of credit issued to Edmund A. Gann, et al., will be cancelled shortly in connection with the sale by a Westgate-California Corporation subsidiary of the so-called "Gann Fleet" of tuna vessels.

- more -

The actions taken to date by the FDIC Board of Directors leave approximately $1.8 million in principal amount of standby letters of credit on USNB's books the date it closed as to which no determinations have yet been made by the agency. In these cases, the holder has incurred no liability, claims have not been filed, or additional information has been requested.

LETTERS OF CREDIT DETERMINED BY FDIC
TO REPRESENT INTERBANK LOANS AND DEPOSITS AND ASSUMED BY
CROCKER NATIONAL BANK

COUNTRY	HOLDER	LETTER OF CREDIT	PRINCIPAL AMOUNT	INTEREST (IF ANY)
AUSTRIA	Girozentrale und Bank der Oesterreichischen Sparkassen A.G.	70-568	$1,073,507	$
		70-675	2,700,000	
BELGIUM	Credit General, S.A.	70-546*	1,000,000	
ENGLAND	International Westminster Bank Limited	70-459*	3,500,000	
		70-541*	3,500,000	
		70-622/622A*	3,000,000	
	Barclays Bank International Limited	70-617*	2,000,000	113,125.00
		70-641*	1,000,000	47,468.75
		70-642*	1,000,000	47,468.75
		70-652*	500,000	23,734.37
	Cooperative Commercial Bank Limited	70-543*	2,000,000	151,229.17
		70-655	500,000	
	Mercator Investment Company	70-597*	529,385.42	
FRANCE	Banque Francaise du Commerce Exterieur	70-559*	1,072,239.58	
	Interunion - Banque	70-565*	1,072,239.58	
GERMANY	Bayerische Hypotheken - und Wechsel Bank	70-544*	2,000,000	139,409.72
	Westdeutsche Landesbank Girozentrale	70-632*	2,177,430.75	
		70-633*	3,266,146.21	
IRELAND	Bank of Ireland	70-608*	529,986.11	
LEBANON	Beirut Riyad Bank	70-582*	1,403,519.10**	
		70-585*	701,759.56**	
		70-586*	701,759.56**	
		70-587*	701,759.56**	

COUNTRY	HOLDER	LETTER OF CREDIT	PRINCIPAL AMOUNT	INTEREST (IF ANY)
LUXEMBOURG	Hypobank International, S.A.	70-676*	$ 2,000,000	$
	Overseas Compagnie de Finance et d'Investissement, S.A.	70-589*	500,000	
NETHERLANDS	Algemene Bank Nederland N.V.	70-686*	500,000	25,909.73
PANAMA	Georco Investment and Finance Company, Inc.	70-547*	1,000,000	
SPAIN	Banco Popular Espanol	70-678	1,000,000	
	Banco Atlantico, S.A.	70-556	1,074,140.62	
		70-600	1,000,000	
SWEDEN	Sveriges Kreditbank	70-609*	1,000,000	84,913.19
UNITED STATES	New Jersey Bank N.A.	70-596-A*	529,385.42	
	Exchange Place Corporation	70-595*	530,222.22	
		70-613*	542,854.17	
	Isramerica Corporation	70-594*	530,222.22	
		70-614*	542,854.17	
	Marine Midland Bank - Western	70-588*	1,000,000	
		Totals	$47,679,411.25	$633,258.68

*Paid by Crocker National Bank prior to close of business July 1, 1974 in accordance with Purchase and Assumption Agreement with FDIC as Receiver.

**Represents cost in dollars of payment in Lebanese pounds as required by terms of letter of credit.

LETTERS OF CREDIT DETERMINED BY FDIC
TO REPRESENT CONTINGENT LIABILITIES OF
USNB ON DIRECT LOANS BY HOLDERS TO ACCOUNT PARTIES NAMED
(NOT ASSUMED BY CROCKER NATIONAL BANK)

COUNTRY	HOLDER	LETTER OF CREDIT	AMOUNT	ACCOUNT PARTY TO WHOM DIRECT LOAN WAS MADE
CANADA	The Royal Bank of Canada	70-251	$1,200,000	West Coast Properties, Inc.
ENGLAND	Coutts and Company	70-558	5,000,000	Tri-County Ranches, Inc.
	International Westminster Bank Limited	70-536*	4,000,000	Westgate Plaza
	International Commercial Bank Limited	70-523*	3,900,000	Westgate Plaza
		70-524	2,800,000	Roberts Farms, Inc.
FRANCE	Societe Generale	70-620	3,000,000	Roberts Farms, Inc.
		70-639	1,000,000	Westward Realty Co.
		70-677	3,500,000	Tri-County Ranches, Inc.
GERMANY	Westdeutsche Landesbank Girozentrale	70-666	3,000,000	Roberts Farms, Inc.
LUXEMBOURG	Hypobank International, S.A.	70-604	5,000,000	Tri-County Ranches, Inc.
		70-683	321,041.85	Tri-County Ranches, Inc.
	Compagnie Financiere Herstatt, S.A.	70-647	600,000	Golden West Airlines, Inc.
UNITED STATES	First Empire Bank-New York	70-515	2,000,000	Westward Realty Co.
		70-612	2,000,000	Los Altos Management Co.
	Edmund A. Gann, et al.	G-101 to G-108**	5,082,000	Westgate Sea Products, Inc.
		TOTAL:	$42,403,041.85	

* These letters of credit cancelled on June 25, 1974 in connection with the sale of Westgate Plaza Hotel, San Diego, in which lending banks held first mortgage position.

** These letters of credit due to be cancelled upon consummation of the sale of the "Gann Fleet" in which holders have first lien position.

LETTERS OF CREDIT CANCELLED BY USNB
PRIOR TO CLOSE OF BUSINESS OCTOBER 18, 1973

FRANCE	Credit du Nord	70-567	$1,072,239.58
UNITED STATES	Fidelity and Deposit Co.	70-573	102,200

FDIC
FEDERAL DEPOSIT INSURANCE CORPORATION

NEWS RELEASE

CORRECTION OF PR-39-74 (7-2-74)

Re: FDIC CLASSIFIES ADDITIONAL $2 MILLION OF DISPUTED LETTERS OF CREDIT ISSUED BY UNITED STATES NATIONAL BANK, SAN DIEGO, AS INTERBANK LOANS OR DEPOSITS AND RELEASES DETAILS OF PRESENT STATUS OF ALL LETTER OF CREDIT CLAIMS REVIEWED TO DATE

This is a correction in the listing of United States banks on Page 2 of the appendix, "LETTERS OF CREDIT DETERMINED BY FDIC TO REPRESENT INTERBANK LOANS AND DEPOSITS AND ASSUMED BY CROCKER NATIONAL BANK."

New Jersey Bank N. A. should be listed in place of New Jersey National Bank.

Memo of settlement between Federal Reserve Bank of New York and Società Generale Immobiliare S.p.A. of Rome

Memorandum stating terms of preliminary understanding settling claim of Federal Reserve Bank of New York ("FRB") in respect of 13 foreign exchange contracts acquired by FRB from Franklin National Bank on September 26, 1974 and confirmed by Edilcentro International Ltd., Nassau, to FRB on September 30, 1974.

Principal amount of settlement: 6.75 million US dollars.
Term of payment: 10 years.
Interest rate: 7 1/2% per annum on unpaid principal.
Interest payments: Annually on anniversary date of obligation commencing on 3rd anniversary date (i.e., 1st 3 years interest payable at end of 3rd year).
Prepayments: Optional, at any time in whole or in part without penalty or premium.
Payee: Federal Reserve Bank of New York.
Place of payments: New York, New York.
Guarantee of payment: By prime Bank acceptable to FRB.
Effective date: Agreement to be executed on or before July 15, 1975, to be effective July 1, 1975.
Conditions precedent: All necessary corporate and USA and Italian Governmental approvals.
Bank guarantee of payment acceptable to FRB.
Form and substance of documents of agreement and related instruments acceptable to FRB.
Special condition: No public announcement of settlement without prior approval of both parties.

June 18, 1975

Società Generale Immobiliare S.p.A. of Roma

by _____
Ing. Arcangelo Belli
Amministratore Delegato

Federal Reserve Bank of New York

by _____
Leopold S. Rassnick
Assistant General Counsel

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, D.C. 20429

OFFICE OF THE CHAIRMAN

APR 16 1975

The Honorable Edward H. Levi
Attorney General
Washington, D.C. 20530

Dear Mr. Attorney General:

Subject: Foreign Litigation

The purpose of this letter is to inform you of certain litigation outside the United States in which this Corporation is now or may shortly become involved.

On October 8, 1974 the Franklin National Bank ("Franklin") was closed by the Comptroller of the Currency. On the same day, the Comptroller of the Currency appointed the Federal Deposit Insurance Corporation (the "FDIC") as receiver of Franklin pursuant to Title 12 U.S.C. §§ 191 and 1821(c). Later the same day the FDIC, as receiver, transferred substantially all of Franklin's assets to the European-American Bank & Trust Company and the FDIC in its individual capacity.

Among the Franklin assets transferred to the FDIC in its individual capacity were two Eurodollar deposits totalling $15,000,000, which had been placed with an Italian bank with headquarters in Milan, Interbanca-Banca Per Finanziamenti A Medio Termine, S.p.A. ("Interbanca"). The deposits had originally been made in October 1972, and rolled over at six-month intervals thereafter. By the terms of the most recent roll overs, arranged in April 1974, the two deposits fell due, respectively, on October 10, 1974 and October 24, 1974. Prior to its closing, Franklin notified Interbanca that it would not roll the deposits over for another term and demanded repayment of both deposits plus accrued interest of $850,460.07. The FDIC has repeated the demand for payment, but no payment has been made.

On October 31, 1974, the FDIC commenced a suit against Interbanca in the United States District Court for the Southern District of New York to compel repayment of the two deposits. Because the FDIC was uncertain as to whether Interbanca's activity in New York was sufficient to subject it to in personam jurisdiction, the FDIC obtained an order of attachment against such property of Interbanca as could be found within the Southern District of New York. Two bank accounts with aggregate balances of $137,538.61 were levied upon and seized.

Interbanca has not yet answered the complaint but, by a motion to dismiss, has attacked the District Court's quasi-in-rem jurisdiction on the grounds that the attachment on which such jurisdiction is based is unconstitutional. The District Court declined to rule on the motion or on Interbanca's alternative request that it be permitted to defend the suit by a limited appearance. Instead, the parties were ordered to prepare for a hearing on the issue of whether the District Court has personal jurisdiction over Interbanca.

Even if the District Court eventually holds that Interbanca is subject to its long-arm jurisdiction and grants a judgment for the FDIC on the merits, it is possible that an Italian court, in a subsequent suit to enforce that judgment in Italy, might decide that the District Court was without jurisdiction over Interbanca. Because of that possibility, the uncertainty as to how the District Court will resolve the jurisdictional issues before it and the relatively slow pace of the pending suit, the FDIC sought the opinion of an Italian law firm, Studio Legale Ardito, as to the probability of recovering the sums owed through an independent action against Interbanca in Italy. Italian counsel has advised that, based upon the facts related to him, there exists a valid cause of action under Italian law. Accordingly, the FDIC has requested Studio Legale Ardito to bring suit against Interbanca in Italy as soon as pleadings can be prepared.

A second action arises out of Franklin's foreign exchange dealings. Twelve days before it was closed, on September 26, 1974, Franklin sold and assigned all of its right, title and interest in its executory ("forward") foreign exchange contracts to the Federal Reserve Bank of New York (the "FRB"). The contract between Franklin and the FRB provided that the gains and losses (including expenses) realized by the FRB on such contracts would be aggregated. Any net profits realized would be paid to Franklin by the FRB. Any losses in excess of the sum foreseen by the contract would be made good to the FRB by Franklin.

Upon the closing of Franklin, the FDIC in its individual capacity agreed to assume all debts owed by Franklin to the FRB, including Franklin's liability for excess foreign exchange losses. By a separate contract, the FDIC is entitled to certain assets of Franklin, including the right to receive any net profits from the foreign exchange transactions.

Among the forward foreign exchange contracts entered into by Franklin were a series of thirteen contracts made in February and March of 1974 with Edilcentro International Ltd. ("Edilcentro"), a Bahamas company wholly owned by Societa Generale Immobiliare ("SGI"), an Italian company allegedly controlled at the time by the Sindona interests. These forward contracts were to be performed in February and March 1975.

On September 26, after buying Franklin's foreign exchange contracts, the FRB asked Edilcentro to confirm the existence and terms of the thirteen outstanding contracts. Edilcentro did so on September 30, 1974. During the following two months, the FRB and Edilcentro corresponded about the possibility of closing out the contracts early by compensating each other for the changes in market rate up to the time of settlement. The discussions ended inconclusively. None of the thirteen contracts were performed; had they been the FRB would have realized a profit of approximately ten million dollars.

On December 20, 1974, without prior notice, SGI began an action in the Supreme Court of the Bahamas against Edilcentro, two directors of Edilcentro, and Franklin National Bank, in which it sought a declaration that the foreign exchange contracts between Franklin and Edilcentro were ultra vires Edilcentro's charter and an injunction against their performance. Similar actions were begun at the same time against Swiss Bank Corporation (since settled out of court) and Banque de Financement SA. The FDIC learned of these proceedings in January, and was actually served with process (in New York, by leave of the Bahamas Court) on February 12, 1975.

The FDIC has consulted both English and Italian counsel, and on their advice proposes to file a counterclaim against SGI in the Bahamas action for the full amount of the profits lost by reason of Edilcentro's nonperformance. At the same time, the FDIC is contemplating an action against SGI in Italy based, among other things, on the Italian doctrine under which a stockholder may be liable for the debts of a company of which it owns all the shares. The FRB, as the present holder of the contracts with Edilcentro, will probably be a party to these actions.

Sincerely,

(Signed) Frank Wille

Frank Wille
Chairman

cc:
The Honorable Henry A. Kissinger
Secretary of State

The Honorable Arthur E. Burns
Chairman, Board of Governors
Federal Reserve System

The Honorable Alfred Hayes
President
Federal Reserve Bank of New York

FDIC
FEDERAL DEPOSIT INSURANCE CORPORATION

NEWS RELEASE

THE FDIC AND FRANKLIN NATIONAL BANK: A REPORT TO THE CONGRESS AND ALL FDIC-INSURED BANKS

Presented by

Frank Wille, Chairman
Federal Deposit Insurance Corporation

Before the

81st Annual Convention

of the

Savings Banks Association of New York State

Boca Raton, Florida

November 23, 1974

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It is now a matter of history that Franklin National Bank ("FNB"), the nation's twentieth largest bank nine months before, was declared insolvent by the Comptroller of the Currency at 3:00 p.m., Eastern Daylight Time, on Tuesday, October 8, 1974. Pursuant to law, the Comptroller of the Currency simultaneously appointed the FDIC receiver of the Bank. The FDIC Board of Directors (Frank Wille, Chairman; James E. Smith, Comptroller of the Currency; and George A. LeMaistre, Director) convened immediately thereafter at the Federal Reserve Bank of New York to accept one of the bids received earlier that day from four sound banks for the assumption of all of Franklin's deposit liabilities (then approximately $1,369,000,000), the assumption of certain other designated balance sheet liabilities (amounting to approximately $266 million), and the purchase of Franklin assets of equal value (less the purchase price bid), including a right of first refusal on each of Franklin's 104 offices.

The winning bid of $125 million, the highest of the four submitted, came from European-American Bank & Trust Company ("European-American"), an FDIC-insured State nonmember bank owned jointly by six large European banks with combined assets in excess of $90 billion. Since European-American, like the other

three bidders for FNB's banking business, declined to accept FNB's trust business on the terms offered by the receiver, the FDIC accepted a contingent bid of Bradford Trust Company, an FDIC-insured State nonmember which was already servicing a large portion of FNB's corporate trust business, to purchase all of the Bank's trust department. Further approval was given to the European-American transaction by the FDIC Board of Directors as the responsible agency under the Bank Merger Act, and the necessary State approvals for both transactions were received shortly thereafter from the New York State Banking Board, which had commenced a special meeting at 1:00 p.m., and from the New York State Superintendent of Banks. The FDIC then petitioned The Honorable Orrin G. Judd, the judge previously assigned to the matter by the United States District Court for the Eastern District of New York, for his approval of each of the proposed transactions under applicable provisions of the National Bank Act. After an ex parte hearing at which all of the final documents were entered into the record and sworn affidavits were received from the Comptroller of the Currency and myself, the court approved both purchase and assumption transactions.

The next morning, European-American reopened all of FNB's 104 offices, thereby providing uninterrupted banking service

for all FNB customers, while Bradford Trust Company similarly continued the Bank's trust business without interruption. In all, some 630,000 FNB depositors, including 6,000 whose individual deposits exceeded the $20,000 insurance limit, and the beneficiaries of some 3,000 trust department accounts at FNB were fully protected with no apparent interruption in the banking services provided them.

The transfer of FNB's deposit and trust business went so smoothly, it looked easy. But the events of October 8 were in fact the culmination of five months of activity in which five Federal agencies, the New York State Banking Department, the New York Clearing House Association, some twenty different commercial banks or their parent holding companies, and even Franklin National Bank itself participated. My purpose in this report is to detail for the record FDIC's participation in the events of those five months.

May and June

The FDIC was informed Thursday evening, May 9, by the Comptroller's Office that public announcements to be made the next day by FNB's parent ("Franklin New York") might well precipitate a crisis of confidence in the Bank. I was told that Franklin New York would announce the passing of its regular quarterly dividends, that the Bank also had sizeable foreign exchange losses of undetermined

amount, and that there existed the possibility of a serious, adverse reaction which might include a "run" on the deposits of the Bank.

Franklin New York's press announcement, coming on the heels of an April release reporting first quarter earnings down sharply to only two cents per share and the Federal Reserve's May 1 denial of Franklin New York's proposal to acquire Talcott National Corporation, provoked an immediate public, or at least institutional, reaction. Large scale withdrawals on Friday, May 10, coupled with the inability of FNB to borrow significant amounts in the Federal Funds market, forced the Bank to the Federal Reserve discount window later the same day, where it remained continuously thereafter through October 8. Franklin New York followed its Friday announcement with a Sunday press release indicating substantial foreign exchange losses due to "unauthorized" trading, a plan to raise $50 million in new capital through a rights offering, and the likelihood of significant management changes on Monday. In a special release issued Sunday, May 12, the Vice Chairman of the Federal Reserve Board of Governors, announced that the Federal Reserve System, having been assured of the solvency of Franklin National Bank by the Comptroller of the Currency, stood ready to advance to FNB the liquidity funds it needed "within the limits of the collateral that can be supplied." On Monday,

Franklin New York announced the firing of its president and chief administrative officer, who also held similar posts at FNB, and the resignation of its chief international executive. This contributed to a further erosion of public confidence and by the close of business Wednesday, May 15, less than four business days after the first of these series of announcements, FNB's loan at the Federal Reserve discount window had reached $780 million. A steady stream of adverse newspaper comment, including allegations that the true extent of the Bank's deteriorating condition was being suppressed by incomplete and inaccurate statements issued by the Bank's management and successive management requests for the SEC to suspend trading in Franklin securities, only made matters worse as institutional depositors and foreign banks with maturing CDs refused to renew them.

On May 14, the Comptroller of the Currency commenced a new evaluation of FNB's loan portfolio in order to update the results of a November 1973 examination which had shown a significant adverse change in the condition of FNB's loan portfolio compared with the 1972 Report of Examination and in order to assess the full extent of the foreign exchange losses which had not been discovered in the November examination. Shortly before the end of the month,

the Comptroller announced that he had asked the members of the New York Clearing House Association to examine FNB's operations and to make recommendations to strengthen its earnings performance.

By the end of May, FNB's loan at the Federal Reserve window had climbed to $1.2 billion.

During May and June, Franklin's management attempted to generate interest in a prompt merger or acquisition without any special FDIC financial assistance. The Comptroller of the Currency and representatives of the Federal Reserve System put out feelers to the same end, but to no avail, possibly because the financial community was generally aware that the New York Clearing House members had reached a tentative conclusion that an immediate infusion of approximately $250 million from the FDIC would be desirable in any effort to restore public confidence in FNB and to reverse its dismal earnings performance. */

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*/ That tentative recommendation was relayed to me by the Comptroller, but he was fully aware of the limited statutory power of the FDIC to grant such assistance and the recommendation was not pressed. An extended discussion of this statutory power was contained in my letter of October 3, 1974, to The Honorable Wright Patman in connection with the proposal submitted by FNB's management in September for FDIC financial assistance to remain an independent, Long Island-based institution.

In these first two months of Franklin's public ordeal, it was agreed between the Comptroller of the Currency, the Federal Reserve System and the FDIC, that the FDIC should stay very much in the background and avoid public identification with efforts to find a solution for FNB's problems. The concern at the time was, of course, that public disclosure of FDIC's interest in the outcome of the Franklin National Bank situation would lead to a general conclusion that FNB's failure was likely, if not imminent. Coming eight months after the FDIC's very public role in the failure of United States National Bank, San Diego, this type of public reaction was seen as a distinct possibility, and it was felt that any public identification of FDIC's role would feed speculation in the press about the Bank's long-run ability to withstand the massive outflow of deposits it was experiencing and, in all likelihood, would prevent the possible consummation of a merger or acquisition without special Government financial assistance or indemnities. As a matter of prudent contingency planning, however, the FDIC was kept informed on a current basis of developments within the Bank, and a group of its examiners joined a special task force of national bank examiners monitoring daily changes in the Bank's condition and Federal Reserve bank examiners who were reviewing the collateral being provided by FNB for its steadily increasing window loan.

In early June, I suggested that this task force of examiners begin pulling together on a crash basis all of the information which might be needed by a prospective purchaser of Franklin National Bank, including detailed information about its loan portfolio, its securities investments, and its deposit structure. Much of this information had to be developed from work papers in the possession of national bank examiners or from information specifically requested of the Bank's management. This joint information-gathering operation concentrated first on the obvious things a prospective purchaser might wish to know about the Bank's operations, its problem areas and the reasons for its poor earnings performance, but in due course, the information base available to us was expanded with greater and greater detail and continually updated throughout the summer so that all concerned might be working with the latest figures. Not coincidentally, the FDIC itself benefitted significantly from the development of this data base since it gave the Corporation as well as prospective purchasers a far better handle on many of FNB's operations than the usual report of examination.

The FDIC also undertook to develop, strictly on a contingency basis, the opening position it would take if, by invitation of the Comptroller of the Currency and the Federal Reserve Board, it were

asked to conduct negotiations with interested banks looking towards an FDIC-assisted purchase and assumption transaction involving all of Franklin's deposit liabilities. For this purpose, we received verbal reports from the three team leaders of the New York Clearing House Association task force which had been analyzing FNB's operations and reviewed all of the information otherwise at hand concerning FNB's condition.

The FDIC's analysis in the development of its negotiating position led it initially to the conclusion that a transaction might be fashioned generally along the lines of the FDIC transaction with Crocker National Bank in October 1973 for the assumption of all the deposit liabilities of United States National Bank, San Diego. There were, however, recognized differences between the two situations. Despite a wide variety of rumors centering on Michele Sindona, Franklin's control shareholder, the Comptroller's reports of examination showed little reason to believe that the Bank's operations were riddled with fraud based on a conscious effort to favor the business interests or overseas banking connections of this shareholder. We saw no reason, therefore, to carve out of the assets and liabilities to be transferred, as we had in the United States National Bank failure, those assets and liabilities related to

the Bank's controlling shareholder or his various interests. We anticipated, however, that any FDIC-assisted transaction would have at least three components included in the United States National transaction: (1) an FDIC indemnity against FNB liabilities not specifically assumed by the purchasing bank; (2) a "put-back" provision of undetermined amount whereby the purchasing bank could return to FDIC as potential receiver of FNB classified, low-yield or otherwise undesirable loans and securities; and (3) an FDIC purchase of a capital note issued by the purchasing bank.

The FDIC made two basic decisions at this time which had a significant effect on the subsequent negotiations it would conduct as potential receiver of Franklin National Bank and on the eventual form of the purchase and assumption transaction with European-American. The first was to require competitive bidding by more than one bank on a uniform basis, if this were possible. The second was not to contribute in cash more than the $750 million estimated to be necessary to pay off all insured depositors up to the $20,000 insurance limit then in force.

The reasons for these two decisions were relatively simple. As receiver of a closed bank, FDIC has a fiduciary duty to the creditors of the bank and to its owners to realize the highest price

it can get for the going concern value of the closed bank's business. It also has a statutory duty to minimize its own loss. In carrying out these responsibilities, it has been, and continues to be, FDIC's experience that competition between two or more prospective bidders for the assets, deposits and offices of a closed bank is the environment most likely to result in the fairest terms for the FDIC among the myriad of contractual provisions that are possible and the most likely to bring the highest price for the going concern value of the closed bank's business. A negotiated deal with only one institution, or a bidding procedure in which there is known to be only one bidder, almost never produces these benefits. The disadvantage of competitive bidding is that developing a uniform basis on which interested parties with diverse interests can bid at the same time is time-consuming and frustrating as prospective bidders seek to gain advantages for themselves or to impose disadvantages on their opponents by particular contract provisions. In most disputes, however, the competitive bidding process tends to insure that a reasonable allocation of risk between FDIC and the successful bidder will be reflected in the final bid package. As to the price results of competitive bidding, we at the FDIC have seen time and again the wide spread between high and low bids submitted on the

same bid package -- the spread in FNB's case amounting to exactly $100 million -- and we know of no fairer way to establish a true value for the proposed transaction.

Our decision not to lay out more in FDIC cash than would be required in a statutory payoff of the $20,000 insurance limit was equally pragmatic. If the maximum exposure of the FDIC fund under its insurance commitment was $750 million, and if the FDIC statute provided, as it does, that we should elect either a payoff of $20,000 per depositor or a purchase and assumption transaction with a sound bank depending on which is most likely to "reduce the risk or avert a threatened loss to the Corporation," we could see no way of justifying to the Congress, or to FDIC-insured banks which have contributed over the years to the FDIC trust fund, a cash outlay, even on a temporary basis, of more than the FDIC might be required to advance in a statutory payoff.

This second decision had one immediate consequence for the Federal Reserve System whose window loan to FNB already exceeded $750 million: we would not under any circumstances pay off this loan in full on the day FNB might be declared insolvent, even though that had been our practice in all recent bank failures that had resulted in an immediate purchase and assumption transaction. Moreover,

even without the immediate repayment by FDIC of the Fed's window loan, it appeared quite possible that other provisions of the purchase and assumption agreement might result in an initial FDIC outlay approaching $750 million. FDIC agreement, for example, to purchase a capital note of the successful bidder in the range of $200-$300 million, to buy back unwanted loans and securities in the range of $300-$400 million, and to establish a reserve for possible "errors and omissions" in the scheduling of assets purchased by the assuming bank could well have brought FDIC to the same outlay as a statutory payoff without regard to the repayment status of the Federal Reserve loan. For FDIC to have agreed as well to pay off the Fed's window loan immediately upon its appointment as receiver might thus have required the liquidation of about one-third of the $6 billion fund FDIC had accumulated over a period of forty years. It was our belief that given the economic uncertainties of the times and increasing questions about the stability of the banking system, we would have lost as much or more in public confidence by a $2 billion reduction in the FDIC insurance fund as we would have gained by a speedier resolution of the Franklin National Bank's problems. We felt obliged, in other words, to protect as much of the federal deposit insurance fund as possible against the unknown contingencies of the future, while

recognizing at the same time a clear statutory duty to advance $750 million in the event of a statutory payoff up to the $20,000 insurance limit.

This basic decision meant that, if, as and when we were called upon to initiate discussions with banks interested in an FDIC-assisted purchase and assumption transaction, some way would have to be found to pay off the FNB loan at the Federal Reserve window other than with FDIC cash. One obvious possibility was to insist that the purchasing bank assume the responsibility for repaying this FNB liability if it wished to purchase the assets held by the Federal Reserve as collateral for the loan's repayment. In preparation for discussing this possible aspect of the contingency plan we were developing, we solicited and received from the Board of Governors of the Federal Reserve System an expression of its willingness, as well as the willingness of the Federal Reserve Bank of New York, to continue the window loan for some purchasing bank and of the conditions for such an extension of the loan in the event of a successful purchase and assumption transaction.

By July 1, the loans secured by FNB collateral on deposit with the Federal Reserve System had reached $1,455,000,000, while the deposits of the Bank had shrunk to slightly over $2 billion.

compared with $3.2 billion on May 14. Most of this deposit decrease was caused by the withdrawal of uninsured foreign and institutional deposits, although there had been, and continued to be throughout the summer, a steady but much slower rate of outflow in other types of deposits as well. By that date, it was also obvious that efforts to work out a merger or acquisition on a bank-to-bank basis without FDIC assistance had been fruitless.

July 2 - August 12

On July 2, the Comptroller of the Currency informed me by letter that he had concluded that the most constructive approach to be taken, under these circumstances, was to explore the possibilities for an assisted sale of either all or part of Franklin's assets and the assumption of its deposit liabilities. He requested, as the Federal Reserve System had several weeks earlier, that the FDIC initiate discussions with banks in the State of New York and such foreign banks as it deemed appropriate to explore the possibility of consummating such an assisted transaction. The importance of presenting one negotiating posture to potential bidders was obvious, even though the negotiations would clearly require coordination among the three banking agencies in Washington, the Federal Reserve Bank of New York, the New York State Banking Department and the Antitrust

Division in the Department of Justice. It was agreed, therefore, that while each of the bank supervisory agencies could be represented at all negotiating sessions if it wished, only one person could, as a practical matter, lead the Government's negotiating efforts, and I was designated for this purpose.

Immediately after receiving the Comptroller's letter, I communicated with twenty banking organizations headquartered or represented in New York State about their possible interest in such an assisted transaction. In addition, at my request, the Board of Governors communicated with the Bank of England, the Bank of Japan and the Bank of Canada to determine if the larger banks in those countries with offices in New York might be similarly interested. Between July 5 and July 12, I held separate meetings at the FDIC Building in Washington with thirteen of those contacted, and subsequent to July 15, with three others. In these sixteen meetings,*/ each of which lasted approximately two hours, our visitors were

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*/ Held with First National City Bank, The Chase Manhattan Bank, N.A., Manufacturers Hanover Trust Company, Chemical Bank, Bankers Trust Company, Charter New York Corporation, Marine Midland Banks, Inc., The Bank of New York, European-American Bank & Trust Company, Barclays Bank of New York, Algemene Bank Nederland, N.V., Royal Bank of Canada Trust Company, First Commercial Banks, Inc., United Bancorporation, Lincoln First Banks, Inc., and First Empire State Corporation.

provided with as much detailed information about the Franklin's condition as we were then in a position to give them. This information included the open portion of the Comptroller's Report of Examination commenced November 14, 1973, his updated report of May 14, 1974, his most recent Report of Examination of FNB's trust department, the Bank's filings with the Comptroller as to its data processing operations, general information about the Bank's 104 offices, and a compilation of special information prepared by the joint agency task force of examiners which had been at work at the Federal Reserve Bank of New York. This additional compilation included breakdowns of the Bank's statement of condition as of June 10, profit and loss statements of the parent holding company and of the Bank's London branch as of May 31, a detailed breakdown of various accounts on the Bank's balance sheet including a maturity schedule for the Bank's investment portfolio, information as to the average yield on different categories of FNB securities and loans, the cost of its time deposits, schedules of maturities on its certificates of deposits and of the interest rates they carried, a schedule of the Bank's borrowings as of June 21 and of the approximate amount of the collateral pledged to the Federal Reserve for its window loan, information as to FNB's employee benefit plans, certain summary information as to the

operations of FNB affiliates, and a listing of certain of the Bank's known contingent liabilities.

In addition to this basic information about FNB, I also discussed in general terms the kind of FDIC and Federal Reserve assistance which might be available in the event of Franklin's insolvency and the kinds of purchase and assumption transactions which FDIC had successfully concluded in the past. I also placed on the table for each group's consideration our tentative thoughts with respect to a possible purchase and assumption transaction in this instance. This outline contemplated the assumption of all FNB deposit and other balance sheet liabilities, including FNB's liability on its Federal Reserve window loan, and the purchase of essentially all FNB's assets subject to a "put-back" provision to the FDIC in an amount to be negotiated. I made it clear that the FDIC would be prepared to sign its usual indemnity agreement against liabilities which had not been specifically assumed and would be prepared to subscribe to a capital note of the purchasing bank in an amount at least equal to the $50 million provided Crocker National Bank in the United States National Bank failure.

Each group was asked to analyze the information provided and to relay to me as promptly as possible an expression of its top

management's preliminary reaction, whether positive or negative. I indicated that in our own review of these discussions, it would be most helpful to have a candid explanation as to the reasons why each group reacted the way they did. I further indicated that there was considerable urgency in the promptness of their response, since we did not know how fast FNB's deposits would run out or how quickly FNB's window loan might exhaust its eligible collateral. We recognized, however, that since the information we had provided was voluminous and since the proposed transaction was of the magnitude outlined, it would probably take at least a week for most of our visitors to analyze the material presented and to brief key officers and directors before arriving at even a tentative reaction. In fact, although some of these sixteen groups were quite prompt in reporting their reactions, particularly those that were negative for one reason or another, others pursued their analyses more slowly. By the end of July, it was apparent that only one bank was definitely interested in pursuing what we at the FDIC came to call the "$4 billion" proposal for resolving FNB's problems (i.e., by assuming all of FNB's balance sheet liabilities and most of its assets). Many of the banks reporting a negative reaction stressed the magnitude of the proposed acquisition and the effect on their own earnings and their

own stock performance of taking over FNB's low-yielding assets, particularly if they were not much larger than FNB itself. Several expressed the view that they could not justify the commitment of management time necessary to work out FNB's problems or the capital commitments necessary for such a transaction. In addition, a number of our visiting banks pointed out that the Federal Reserve Board was demanding, in its bank holding company decisions, a higher standard than heretofore of capital adequacy in the face of holding company growth, and that they already felt under significant pressure to improve their capital positions without the added burdens of an FNB acquisition.

Based on these reactions, which revealed far more interest in parts of FNB than in the whole of FNB, the FDIC proposed to the Federal Reserve System an alternative transaction whereby, in the event of FNB's insolvency and FDIC's appointment as receiver, FDIC in its corporate capacity and not as receiver would assume FNB's liability on its loan from the Federal Reserve Bank of New York and would pay this off over a reasonable number of years as it collected FNB assets of equal or greater book value. Concurrently, a bidding bank would be asked only to assume FNB's deposit liabilities and other nonsubordinated balance sheet liabilities exclusive of the

Federal Reserve window loan. In exchange, a bidding bank would acquire FNB assets of its own choosing, free of any security interest of the Federal Reserve, of a value equal to this smaller total of liabilities to be assumed (value to be measured by fair market value in the case of securities, real estate, furniture and fixtures and by book value in the case of loans and cash-type items) less a premium which would constitute its purchase price for the transaction. The effect of this proposal, insofar as prospective bidders were concerned, was to reduce the magnitude of the overall transaction from something less than $4 billion to something less than $2 billion. This would reduce the magnitude of the earnings risk they were being asked to undertake and the magnitude of the new capital that might be required. If this scaled-down version of an FNB acquisition were presented to those banks which had expressed an interest in some but not all of the Bank's assets and liabilities, it was my belief that five or more banks or bank holding companies might eventually become serious bidders for the total transaction offered. The Federal Reserve System readily agreed to this concept, and in early August, as we were awaiting the last responses from the banks initially briefed in July, this alternative plan was placed before all of them for consideration.

On August 6, acting upon a suggestion from a number of the groups with which we had talked, FDIC solicited the views of the Antitrust Division as to whether and under what circumstances banks interested in some part, but not all, of FNB's assets, deposits and offices might jointly prepare a single bid for the same type of transaction. The FDIC's letter to the Antitrust Division, and the Antitrust Division's prompt response to this inquiry (which was generally favorable so long as no more than one of the five largest retail banks in the New York metropolitan area were included in any one bidding group) were both transmitted to each of the interested banks which had met with FDIC about an assisted transaction.

Meanwhile, the Federal Reserve and FDIC agreed on the basic terms of the agreement which was later entered into between them for the repayment of the Federal Reserve's window loan and for the release of the Federal Reserve's security interest in those assets which might end up in the hands of the purchasing bank as part of its selection of FNB assets (the Federal Reserve's security interest in FNB assets held by FDIC, however, would continue until FDIC disposes of the asset). We agreed, for example, that regardless of the FDIC's collection on the assets it held, the net proceeds of which would be paid to the Federal Reserve on a periodic

basis, FDIC would pay off this loan in full at the end of three years. By that time, based on our collection experience in other liquidations, we anticipated a remaining balance of $500 million or less, the payment of which would then represent about one year's net addition to the FDIC fund. Subsequent to that payment, the FDIC would have the right, of course, to continue to collect any remaining assets it held in order to reimburse itself for the final cash payment to the Federal Reserve. We agreed that collections would be applied first to outstanding principal and then to accrued interest, that the rate of interest on the Federal Reserve loan subsequent to FNB's closing would be the average portfolio yield of the System Open Market Account on the day of closing (subsequently determined to be 7.52% per annum), and that FDIC would be able to deduct from its interest accruals out-of-pocket liquidation expenses up to a maximum amount of $5 million per year.

The public policy implication of the FDIC agreement with the Federal Reserve as to the repayment of FNB's window loan is that the risk of loss on asset collections held to repay this loan was shifted from the general taxpayer, who receives the benefit each year of the surplus revenues of the Federal Reserve, to the nation's federal deposit insurance program, which is funded by the nation's

FDIC-insured banks, not the general taxpayer. We considered this entirely appropriate when the risk of loss had been created in the first place by the management errors of an FDIC-insured bank and not by the nation's taxpayers. I might add that once it became clear that it would not be possible to create a competitive bidding situation for a $4 billion transaction in which the Federal Reserve window loan would be assumed by the purchasing bank, there was never any question that as between the Federal Reserve System and the FDIC, the FDIC fund should bear the ultimate risk of loss on this window loan. Our final agreements with the Federal Reserve reflect this view.

August 13 - October 8

Serious efforts to develop the precise form of such a scaled-down transaction, price alone excepted, were commenced by me at the Federal Reserve Bank of New York on Tuesday, August 13, with officers of six banks which had indicated varying degrees of interest in the plan in attendance, as well as their counsel and representatives of the other Federal banking agencies. The intent of these meetings, and of later meetings of counsel and operating officials, was to develop a common set of bidding documents on which each seriously interested contender could bid competitively in the event that FNB

were declared insolvent and FDIC became receiver. We also had to coordinate the actions of the public agencies involved, to plan ahead for the logistical support that would be needed on the day of closing, and to predict the kinds of operational problems that would exist thereafter since the winning bank and FDIC were to end up dividing FNB's assets between them.

From August 13 to October 8 was precisely eight weeks. While we had anticipated reaching a common set of predrafted bidding papers earlier in September than subsequently proved to be the case, there were four particularly troublesome aspects of the transaction which had to be fully explored before either the bidding banks or the FDIC were prepared to go forward. In addition, all six banks wished to have the benefit of a new evaluation by the Comptroller of the Currency of FNB's loan portfolio in view of what they believed to be a deteriorating situation within FNB and in the creditworthiness of certain classes of FNB borrowers. This review was promptly undertaken by national bank examiners on August 14 and completed in final form prior to the end of the month, but there was about a week's hiatus in our deliberations as we awaited the results of that new examination. The four troublesome areas to which we then turned our concentrated attention in September were as follows:

1. FNB's Foreign Exchange Exposure. Franklin National Bank ceased its heavy speculation in foreign currencies as soon as irregularities in its foreign exchange department were discovered and publicized, but the uncovered forward contracts resulting from these activities remained with FNB for workout throughout the summer. Fortunately, the Bank's management was able to obtain the services of Edwin A. Reichers, an experienced and highly regarded foreign exchange trader who had recently retired from First National City Bank, and his success during the summer in reducing the Bank's exposure from an astronomical figure to an increasingly more manageable figure was one of the few bright spots in an otherwise dreary summer for FNB. By early September, however, he reported that he was finding it increasingly difficult to find other foreign exchange dealers, either in the United States or overseas, who were willing to enter into foreign exchange contracts with FNB that might assist the Bank in winding down its exposed position. Moreover, numerous FNB foreign exchange contracts remained to be performed and there was a risk, not easily quantifiable, that parties to contracts favorable to Franklin might find a reason not to honor them.

The disposition of FNB's foreign exchange exposure in any purchase and assumption transaction was thus of considerable importance. The Federal Reserve System, which had been particularly concerned about the international implications of a precipitous failure of FNB from the beginning, considered it imperative for stability in the foreign exchange markets that FNB's unexecuted foreign exchange contracts be honored. FDIC shared that view, but pointed out that if these unexecuted contracts ended up in FDIC's hands as possible receiver, FDIC might have a fiduciary duty to FNB's creditors and owners not to honor those which were unfavorable to the Bank, and to demand performance of those which favored the Bank. We felt, accordingly, that we could give no assurances that all of these contracts would in fact be honored by the FDIC as FNB's receiver. Moreover, any use of the FDIC fund to work out the possible loss involved in an insured bank's foreign exchange position would have come as a great surprise to many who had a different view of the purpose of the fund. Similarly, we doubted the propriety of any explicit FDIC indemnity to an assuming bank against loss in the assumption of FNB's liabilities or risks in the foreign exchange area.

Given this situation, it seemed imperative that either (i) FNB's foreign exchange position and the risk of loss be assumed by the successful bidder without special FDIC indemnities or (ii) that the Federal Reserve System itself take over FNB's foreign exchange position prior to a possible closing. Three of the four bidding banks, however, refused to assume any part of FNB's foreign exchange risk, fearing not merely the monetary consequences of such a takeover (which could have been reflected in the premium bid) but also the likely market reaction to news that they had taken over any portion of the activities which had obviously caused FNB such trouble. Concentrated attention was then given to the ways in which the Federal Reserve Bank of New York could legally take over these unexecuted contracts for performance by its own experienced foreign exchange trading department. The foreign exchange experts of the bidding banks gave individual opinions to the Federal Reserve Bank of New York as to the likely market risks it would incur in covering the limited number of currencies which concerned Franklin, as well as the credit risks of nonperformance on contracts favorable to FNB by parties overseas. The Federal Reserve Bank of New York staff compared these estimates with its own and determined that with a high enough deposit from FNB itself

to cover these various risks, the Federal Reserve Bank of New York could undertake full responsibility for working out FNB's foreign exchange position prior to a potential receivership so long as FNB agreed to make up any short fall in the deposit. Lawyers for the Federal Reserve Bank of New York then drafted the necessary papers by which that agency and FNB could agree to the transfer of FNB's foreign exchange position, including unexecuted contracts and related foreign currency balances, from FNB to the Federal Reserve Bank of New York.

Fortunately, disposing of its foreign currency operations neatly dovetailed with the plan FNB's own management had to retrench to Long Island and withdraw from the international arena. FNB in fact had sought the assistance of the Federal Reserve Bank of New York earlier in the summer in working out its foreign exchange position. I understand that the outline of an agreement to transfer FNB's foreign exchange position to the Federal Reserve Bank of New York was presented to FNB's management at a routine meeting of its top officials with the staff of the Federal Reserve Bank of New York on Monday, September 23, and that the final contracts were fully executed by both parties on Thursday, September 26.

It was agreed that the amount of FNB's deposit to cover the Federal Reserve's risks would be $15,645,000, of which a substantial portion would be paid back to FNB promptly upon confirmation by third parties to these various contracts that they were prepared to perform such contracts with the Federal Reserve Bank of New York rather than FNB. The Federal Reserve Bank of New York thereupon contacted central banks of those European countries in which these third parties were located and sent cables directly to each of the third parties involved explaining the novation and requesting confirmation of their obligations under the contracts the Federal Reserve Bank of New York had assumed. By Tuesday, October 1, virtually all of these third parties had confirmed their willingness to accept the Federal Reserve Bank of New York as the contracting party on these outstanding contracts, and the Federal Reserve Bank of New York immediately released to FNB $5,908,000 of FNB's deposit. The Federal Reserve Bank of New York promptly covered FNB's open positions and all of the contracts are now being executed, some at a profit and some at a loss to the Federal Reserve Bank of New York. As of November 15, the Federal Reserve Bank of New York still held a reserve of $6,088,000 against possible future losses in the performance of the remaining contracts, the last of which will not fall due

until August 1975. The Federal Reserve Bank of New York continues to believe that it will be successful in honoring all of these outstanding contracts without fully depleting the remaining balance of the deposit it received from FNB. In the event that there is a surplus left in this deposit when the last contract has been executed, the remaining amount will be returned to FDIC as FNB's receiver.

The successful resolution of these outstanding unexecuted foreign exchange contracts was a key requirement before the Federal bank agencies were prepared to move on a possible purchase and assumption agreement involving the rest of Franklin's business. Once this matter was resolved, it should be noted that the agencies did move one week to the day after the receipt of all but a handful of the required confirmations on FNB's outstanding contracts.

2. FNB's London Branch. FNB had a well-staffed London branch which had played an important role in FNB's Eurodollar operations and the development of its international business. During the summer, the branch showed on its books more than $600 million in assets, largely Eurodollar loans to overseas borrowers on which the rate of interest was pegged to the London interbank rate on prime quality Eurodollar loans. They were thus among the highest yielding assets in FNB's total loan portfolio and as such were considered a

very significant segment of the assets from which the successful bidder was to be allowed to make its selection of FNB assets to balance off the FNB deposit and other liabilities assumed. The FDIC, as well as each of the prospective bidding banks, therefore, retained through their New York counsel London solicitors to advise upon the impact under English law of the proposed purchase and assumption transaction that was taking shape. In addition, it was essential that the cooperation of the Bank of England be obtained since they held physical custody of many of these assets as agent for the Federal Reserve Bank of New York under a complex security arrangement. So far as any of us knew, this was the first time a United States bank with a full-service overseas branch was faced with a possible finding of insolvency. It was certainly the first time in FDIC history that FDIC might be called on to act as receiver of a bank with a significant portion of its assets overseas.

For a variety of reasons, it appeared desirable that the FDIC's General Counsel and I travel to London in the midst of our negotiations in New York to discuss various ramifications of the proposed transaction with the Governor of the Bank of England and his staff. Accordingly, we made arrangements to visit the Bank of England on Friday, September 20, and utilized the balance of the

same weekend to discuss related matters with our English solicitors and their advisers in London. This visit was extremely fruitful, and the Bank of England was generous in its cooperation and support for the proposed transaction we were negotiating. When Franklin National Bank was in fact declared insolvent and the FDIC appointed receiver, the necessary approvals for transfer of the Bank's London assets to the FDIC were immediately forthcoming under the English Foreign Exchange Controls Act, and other necessary governmental approvals were cleared expeditiously.

3. FNB's Domestic Branches. A close examination by special New York counsel for the FDIC and New York counsel for each of the bidding banks revealed that a substantial number of FNB branch offices were financed under special trust agreements in which the beneficial interests were held by independent third parties. Under one of these agreements, it appeared possible that the assuming bank might be required to elect or reject as a group thirty-three FNB branches without regard to individual location, profitability or mesh with existing branches of the successful bidder. This was clearly unsatisfactory to all the potential bidders, even European-American which had no branch system on Long Island and might have been expected to elect all thirty-three branches as part of its asset

selection. Since each of the banks with whom we were then negotiating had entered into our discussions on the good faith assumption that the asset and branch selection we had promised them would be made available to them, a solution to this problem had to be found and special provisions were written into the proposed purchase and assumption agreement in September in order to assure this result insofar as the thirty-three branch offices in question were concerned.

4. FNB's Trust Department. A final problem area between FDIC and the prospective bidding banks related to Franklin's trust department. Each of the final four bidders were concerned with various aspects of Franklin's corporate trust operation and requested special indemnities, never before given by the FDIC, under some of which the successful bidder would even have been protected against liability incurred because of its own acts subsequent to FNB's closing and the consummation of the purchase and assumption transaction. Moreover, it appeared that none of the prospective bidders wished to assume certain of FNB's pension trust activities for employees of companies that had filed Chapter proceedings under the bankruptcy laws. This was a particular problem for the State-chartered banks among the prospective bidders because of a New York banking law provision which provided that an assuming bank

would automatically become successor trustee only if it acquired all of FNB's trust business. Nor was the New York State Banking Department prepared to initiate a waiver of that provision, since it desired all of FNB's trust business to be assumed the same day FNB's deposits and banking business were assumed. Under these circumstances, it was determined the weekend before October 8 that each of the bidding banks would be given an option in the bidding form to accept or reject all of FNB's trust department on FDIC's terms, and contingency plans were made with Bradford Trust Company to assume the entire department in the event that the successful bidder elected not to accept FNB's trust department in its entirety. This in fact was how events later turned out and the reason why FDIC entered into a separate purchase and assumption contract for Franklin's trust business.

During the first week of October, the various strands of the transaction on which we had been working since July 2 finally began to come together. Each of the major items still open in the negotiations at the beginning of September, including final decisions on the terms of FDIC's capital note assistance for the successful bidder, had been resolved, the FDIC had briefed two hundred of its key supervisory personnel as to their responsibilities in the event

Franklin National Bank was declared insolvent and the FDIC was appointed receiver at a special meeting in Washington on Sunday afternoon, September 29, and it appeared that all four of the prospective bidding banks would be ready to proceed on Tuesday, Wednesday or Friday of the week of October 7. From the point of view of the agencies, a Tuesday or Wednesday closing was preferable to a Friday closing because all FNB offices, with the exception of a few drive-in windows, closed at 3:00 p.m. on those days of the week whereas on Monday, Thursday and Friday a substantial number of FNB offices were open until 8:00 p.m., while others closed at 3:00 p.m. On Saturday, October 5, I informed the Chairman of the Federal Reserve Board and the Comptroller of the Currency that I had commitments to bid in accordance with our proposed bid papers from two of the four banks with whom I had been negotiating and that all of the regulatory agencies appeared ready to proceed if FNB were declared to be insolvent. The decision to go forward on the earliest of the three days possible, namely, October 8, was then quickly made. The rest is now history.

FNB's Efforts to Remain Independent.

During August and September, FNB's management became convinced that with enough FDIC and Federal Reserve assistance

it could remain independent and again become a viable competitor on Long Island. It formally submitted a plan to this effect to the three Federal banking agencies on or about September 16. By the first week in October, each of the agencies reviewing that plan had reached separate but similar conclusions that the plan was not feasible given FNB's past earnings performance and its likely earnings performance in the future based on realistic assumptions as to FNB's capabilities. In addition, FDIC by law has only limited power to assist an open and operating bank and it appeared to be impossible, in the light of the vigorous competition present in the New York banking market, to make the necessary finding that the continuation of Franklin National Bank, as distinct from the continuation of its offices as part of some purchasing bank, was "essential to provide adequate banking service in the community." The reasons for FDIC's rejection of the Bank's plan for an independent FNB were spelled out in greater detail in two letters which are now part of the public file: the first addressed to the Chairman of the House Banking and Currency Committee under date of October 3, in response to specific questions he had directed to me earlier about the cost of the FNB plan to the Government and the financial benefits FNB might be expected to realize if its proposed plan were effected,

and my subsequent letter of October 8 to Joseph W. Barr, FNB's Chairman and Chief Executive Officer, which was delivered shortly before the Comptroller of the Currency served his notice of insolvency on the Bank the same afternoon.

I might say, parenthetically, that the nation's banking system is deeply indebted to Mr. Barr for his stewardship of Franklin National Bank and its parent holding company during this particularly difficult summer. He assumed office late in June after the damage had been done to Franklin, he prevented a bad situation from deteriorating further and he was personally responsible for several important but painful steps the Bank took to improve its operating condition and its future earnings performance. Under his leadership, for example, the Bank ordered additional chargeoffs in its loan portfolio based on the Comptroller's May 14 examination, it wrote off a deferred tax benefit account of increasingly doubtful value, it pursued efforts to work out FNB's foreign exchange exposure, it increased the monthly allocation to FNB's loan loss reserves and it accomplished a significant reduction in force designed to bring under control the Bank's inflated personnel costs and overhead. Although the Bank's loan and deposit business was steadily eroding, many of these steps made FNB in October a more attractive

candidate for a purchase and assumption transaction than it was in May. While we obviously disagreed with the long-run feasibility of his plan to keep Franklin National Bank alive as an independent, Long Island-based institution, we fully understood that his primary obligation was to the creditors and shareholders of the Bank. He performed, in other words, a thankless task the benefits of which should now redound to the benefit of European-American and the creditors and shareholders of FNB.

The Terms of FDIC's Capital Note Assistance.

Shortly before the completion of our negotiations, FDIC resolved the final details of the capital assistance it would offer the successful bidder. The principal question, of course, was amount and this had two facets: (i) the total additional capital which the acquiring bank might require by virtue of the proposed transaction, and (ii) what proportion of that total FDIC should agree to supply. Questions of capital adequacy are essentially questions of judgment, and since the group of potential acquiring banks seemed to be narrowing to one national bank, two State member banks and one nonmember bank, I solicited the views of the New York State Banking Department, the Comptroller of the Currency, the Federal Reserve Bank of New York, the staff of the Board of Governors in

Washington, and the FDIC's own staff as to the appropriate level of overall capital support for a transaction which might, by the closing date, range between $1.5 billion and $1.9 billion in liabilities assumed. From these regulatory sources, the lowest estimate of the capital required solely for this transaction ranged from $110 million in the event of a $1.5 billion transaction to a high of $165 million in the event of a $1.9 billion transaction. The capital positions of the negotiating banks differed one from the other, and their own estimates of the total additional capital needed to support this type of transaction ranged from approximately $120 million to $225 million. In due course, given the continuing slow runoff in deposits (which had the effect of reducing the likely total of liabilities to be assumed), the difficulty of raising new bank capital during the summer, and the pressure being applied to all banks of significant size to meet increasingly severe standards of capital adequacy on the part of the Federal Reserve System in its administration of the Bank Holding Company Act, the FDIC determined that it would offer to fund the entire capital support which it felt this transaction should have and established that support figure at a maximum amount of $150 million.

With respect to the other basic terms of the proposed capital note, FDIC took the position from the start that any FDIC assistance would have to carry a rate of interest as close to the market rate for a publicly issued note of similar terms as we could reasonably make it. It was our position that a subsidized rate below market was inappropriate for any sound institution seeking an acquisition of this magnitude. In addition, it was FDIC's opinion that the statutory authorization for any such assistance contemplated a relatively short period of FDIC capital assistance to tide the acquiring bank over until it could arrange a public issue to replace the FDIC note and that each of the four prospective bidders would in due course have reasonable access to the capital markets for this purpose. FDIC, accordingly, took the position that it would accept a five-year capital note, without amortization, as it had in prior transactions, but that if the final maturity of the note went beyond five years, FDIC would require a reasonable program of amortization. The note finally offered to each bidder carried these terms:

a. Maturity. The first $100 million of capital assistance carries a final maturity of ten years, while the additional $50 million offered by FDIC carries a final maturity of eight years.

b. Interest Rate. The note carries a floating rate of interest set every six months at 100 basis points above the average yield on six U.S. agency obligations maturing in 1982, 1983 and 1984, subject to a minimum rate of 8.00% per annum and a ceiling rate of 11.25% per annum. The initial rate, based on this formula and applicable for the six months ending March 31, 1975, was 10.03% per annum. Since interest rates have fallen considerably since October 8, the rate if computed today would be substantially below the 10.03% rate to which European-American is bound between now and March 31.

c. Amortization. On the first $100 million of the total amount made available by FDIC, there is no amortization of principal for the first five years. For the next four years, the amortization required on this portion of the total note is $15 million per year with a balloon of $40 million at the end of the tenth year. Should European-American request additional FDIC capital support

in an amount not to exceed the remaining $50 million offered by FDIC, the amortization schedule on this additional amount will be zero the first three years, 15% in each of the next two years, 20% in the sixth year, and 25% in each of the next two years, thereby retiring the full amount of any additional capital support by the end of the eighth year.

d. Prepayment Options. Since the purpose of FDIC capital assistance in this and other purchase and assumption transactions is to tide the successful bidder over until it can successfully refinance FDIC's assistance in the capital markets, the FDIC note provides that there will be no penalty for prepayment at any time and, in addition, provides a cash incentive for optional prepayments beyond the mandatory amortization schedule. This prepayment incentive starts at 3% of any optional prepayment made prior to September 30, 1977, and declines gradually over the ten-year life of the basic $100 million note.

I would reiterate that the interest rate carried by this FDIC note is not a subsidized rate but rather a market rate subject to an 8% floor. By contrast, the average yield on the entire FDIC portfolio has been fluctuating recently around 6.20% per annum while new FDIC funds have been invested during 1974 at an average rate of 8.05% per annum. By either measure, the FDIC has not subjected itself to any loss of potential investment income by agreeing to take European-American's note under the terms outlined.

Was an Earlier Resolution of FNB Possible?

There is absolutely no doubt in my mind that a different transaction could have been pasted together on a rush basis at some earlier point in the five months that transpired between the disclosure of FNB's problems in May and the close of business October 8. But I am equally convinced that such an effort would have been a financial disaster for the trust fund FDIC administers.

Under no circumstances would it have been realistic to expect a major bank to incur significant risks to itself or its shareholders merely to oblige a regulatory request to perform a public service by absorbing FNB and its problems. Indeed, no responsible regulatory agency would have desired that result if it meant a second, and

possibly larger, banking crisis a few years from now. The only way to have met both concerns would have been massive FDIC assistance to the acquiring bank.

Thus, if the FDIC had guaranteed an acquiring bank against all risk of loss in the assets of Franklin National Bank, if in addition FDIC had agreed to substitute large amounts of cash for FNB's low-yield assets in order to boost the earnings performance of the resulting bank, and if FDIC had provided much greater capital assistance to support the whole transaction, I suspect a purchase and assumption agreement that would have been equally protective of FNB depositors as the one we achieved could have been effected long before October 8. Similarly, an agreement could have been effected far earlier than October 8 if no effort had been made to insure competitive bidding.

Either type of transaction, however, would have been inconsistent with the statutes under which FDIC operates. In addition, the first would have required a massive invasion of the FDIC fund to solve the problems of only one insured bank. In that depleted state, would the fund have continued to be a significant source of public confidence in the safety of the nation's banking system when the economic climate is so troubled and rumors about particular

banks abound? I doubt it. The second type of transaction -- one effected without competitive bidding -- would have been grossly unfair to FNB's remaining creditors, subordinated noteholders and owners.

Fortunately, we had the time necessary to put together a defensible transaction. We knew late in July, for example, that the pace of FNB's deposit outflow had slowed and that most of the bad news was behind us. We further knew that the Federal Reserve Bank of New York held collateral having an approximate face value of $2.2 billion to secure loans then outstanding in the amount of $1.6 billion, and that it estimated that FNB still had potential collateral left of more than $500 million in face amount to cover additional advances. Under these circumstances, I opted for patience and thoroughness in our negotiations with prospective bidders, and I believe this approach later paid off in the purchase price paid by the successful bidder, in the reasoned allocation of risk between European-American and the FDIC that resulted, and in the smooth transition of FNB's business effected on October 8.

An Estimate of the Financial Risks to FDIC.

The FDIC's only net outlay to date as a result of FNB's failure has been $100 million for the capital note issued by

European-American in connection with its purchase of FNB assets and its assumption of FNB's deposit liabilities. We do not expect to lose one cent on the principal amount of that note, nor do we expect to lose one cent of potential investment income since the interest rate which we expect to receive during the life of that note will substantially exceed the FDIC's rate of return on its portfolio of U.S. Government obligations.

FDIC has already been repaid in full out of asset collections for $500,000 more which it advanced in early October for initial liquidation expenses, and it is anticipated that future liquidation expenses will be defrayed on a current basis out of income and principal collected on FNB assets held for FDIC's account.

The most significant contingent liability which FDIC undertook in connection with the purchase and assumption transaction with European-American, of course, is the agreement to pay off within three years the full amount of FNB's loan at the Federal Reserve discount window at the time it closed ($1,723,000,000) with interest at 7.52% (the average rate of return on the System Open Market Account the same day). Prior to the final maturity of that obligation, FDIC will be collecting interest, fees and principal payments on more

than $2 billion in Franklin assets. Even if some cash outlay from the federal deposit insurance fund is necessary to meet this liability three years from now, it will undoubtedly be far, far less than $1.7 billion. While it is too early to tell the success of our collection efforts over the next three years, we currently believe that any cash outlay required from the FDIC three years hence will be $500 million or less. Since the FDIC will then be adding about the same amount to its trust fund each year, I consider this obligation to be well within the financial capabilities of the FDIC without a significant invasion of its accumulated trust fund. I would repeat what I said earlier, however, that if any FDIC cash must be paid to the Federal Reserve Bank of New York to meet this liability, FDIC thereafter will continue to collect the assets remaining in its hands in order to reimburse itself for the amount of this payment.

The long-term risk to FDIC, then, comes down to the eventual collectibility of the $2.1 billion of assets on FNB's books which FDIC will have in its hands as soon as European-American has completed its selection of the FNB assets it desires -- a process which is already more than half completed but which must be completed in any event by April 6, 1975. In this speculation, I think it would be fair to assume that virtually all loans adversely classified by the

Comptroller of the Currency at his August 14 examination*/ will be included in the FNB loans FDIC will eventually have to administer.

Assuming a 100% loss on all loans classified Loss, a 50% loss on all loans classified Dobutful, and an arbitrary 10% loss on all other loans FDIC receives, including those that were unclassified, FDIC could sustain a loss on loans held of approximately $185 million if $1.6 billion of FNB loans end up in FDIC hands. If the other $500 million of FNB assets in FDIC hands, consisting largely of long-term municipals and other securities and miscellaneous other assets, could then be liquidated at a maximum loss of $100 million, there is some basis for optimism that the Federal Reserve window loan can be repaid in full without loss to the FDIC, since these figures take no account of litigation or bond claims available to the receiver and no account of income earned on the assets held. It is, of course, much too early in the FNB receivership to assess the accuracy of these assumptions (or of any others) or to make predictions of final net loss, if any, either to the FDIC or to subordinated claimants. I cite these figures solely to illustrate the magnitude of the collection

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*/ This examination classified $2.4 million of FNB's loans as Loss, $52.1 million as Doubtful and $145.8 million as Substandard.

problem facing the FDIC as it liquidates FNB assets, and to point out that even mildly different assumptions will produce significantly different loss results because of the large dollar figures involved.

Future Assessments for Deposit Insurance.

Some FDIC-insured banks have already expressed concern about the impact of the Franklin National Bank failure on their deposit insurance assessments for 1975 and future years. While I cannot predict the effect of the FNB failure on assessments in 1976 or later, I can say that the Franklin failure will have absolutely no impact on the level of deposit insurance assessments for the calendar year 1975. We establish our reserves for losses as of December 31 and will be in no position to do that on a considered basis for the FNB failure until European-American completes its selection of FNB assets and we have had an opportunity to evaluate the assets FDIC will then hold. */

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*/ A substantial additional loss reserve in 1975 will undoubtedly be required, however, for the United States National Bank failure which occurred in October 1973. We believe it unlikely, though, that the effective rate of assessment in 1975, after credit for the statutory refund, will vary significantly from a figure of 50% of the statutory rate. In the current year, FDIC-insured banks are paying approximately 46.5% of the statutory rate for their deposit insurance protection.

FDIC NEWS RELEASE

PR-12-75 (2-25-75)

FDIC ISSUES FIRST REPORT ON
FRANKLIN NATIONAL BANK RECEIVERSHIP

Chairman Frank Wille today released the first report on the Franklin National Bank receivership being administered by the Federal Deposit Insurance Corporation. The information that follows is as of January 31, 1975, unless otherwise stated. Mr. Wille further indicated the FDIC's intention to release such reports every three months in an effort to keep Congress, Franklin creditors and shareholders and the public at large fully informed as to the progress of the receivership.

Franklin National Bank ("FNB") was declared insolvent by the Comptroller of the Currency on October 8, 1974, and the Federal Deposit Insurance Corporation was immediately appointed Receiver in accordance with law. Following the receipt of competitive bids, European-American Bank & Trust Company ("EAB") won the right to assume FNB's deposits and certain other liabilities and to purchase assets of FNB in an amount equal to the liabilities assumed less its winning bid of $125 million. Pursuant to predrafted papers, the FDIC as Receiver had agreed that the winning bidder would have the right to select from the entire FNB portfolio assets equivalent to the amount to be purchased. EAB has now completed 96 percent of its required selections of FNB assets, and FDIC is assuming full responsibility for the administration of assets which EAB has rejected.

As of January 31, 1975, EAB had selected $1,430,402,799 of the $1,487,393,453 in assets it was required to select under the terms of the October 8 agreement. As of the same date, EAB had rejected $2,069,325,809 of the $2,170,945,575 in FNB assets it was required to reject under the terms of that agreement. The selection and rejection process is due to end on April 6, 1975, i.e., 180 days after the effective date of the October 8 agreement.

EAB has selected from the assets FNB had when it closed approximately $249,840,425 in cash and due from banks, $370,555,973 in securities, representing the market value on October 8 of securities carried by FNB at a book value of $415,938,318 (the bulk of which were U. S. treasuries and government agencies), and approximately $760,909,435 in loans at FNB's book value. In addition, EAB has selected other assets with a book value of $49,096,964.

Pursuant to the October 8 agreement, all FNB securities selected by EAB were selected promptly after receipt of their respective October 8 market values, the final securities selections having occurred on October 24, 1974. The loans selected by EAB, most of which relate to Long Island or New York City borrowers, can be categorized as follows:

Real estate mortgages	$157,664,320
Installment	186,316,895
Commercial (including real estate equities)	364,376,728
Accounts receivable	19,663,888
Other	32,887,604
	$760,909,435

EAB has requested the transfer of leases on 100 of FNB's 109 branch facilities and has notified the FDIC it will not request transfer of leases on the remaining 9 branch facilities. EAB selected all of the 74 branch facilities which FNB operated on Long Island; it selected 26 and rejected 9 of the 35 branch facilities FNB operated in New York City; and it selected FNB's London branch while rejecting FNB's three other foreign branch facilities.

The assets rejected by EAB are now being administered by FDIC. Approximately $343,078,000 of these rejected assets represent the book value of certain securities held by FNB on October 8, the bulk of which are long-term municipals. An additional $22,800,000 consists of amounts due from ten foreign banks and $72,700,000 consists of amounts due from FNB's London branch for which corresponding liability accounts were not assumed by EAB. Approximately $28,440,000 are interest accruals and $22,148,000 are miscellaneous other assets rejected by EAB. The FDIC also is attempting to collect all of the charged-off loans of FNB other than those in the installment loan portfolio of FNB, all of which were required to be purchased by the winning bidder. The remainder of the assets being administered by the FDIC are loans. These loans, which carry a book value of $1,530,909,000 include the following:

Commercial Loans:		
Real Estate Equities	$231,307,000	
Maritime	65,000,000	
Other Types of Commercial Loans:		
Term	312,590,000	
Demand	89,500,000	
Participations Purchased	1,000,000	
Total Commercial Loans		$699,397,000
Foreign Loans:		
Placed by FNB, London	275,391,000	
Placed by FNB, New York	248,833,000	
Total Foreign Loans		524,224,000
Real Estate Mortgages		188,342,000
Installment Loans		54,656,000
Past due Loans		48,940,000
Accounts Receivable		7,922,000
Other Loans		7,428,000
		$1,530,909,000

Geographically, these loans are spread widely throughout the country. Based on a limited sampling to date, which FDIC believes will turn out to be fairly representative of the entire loan portfolio being administered by the FDIC, 39 percent of the loans held by the FDIC are to businesses or individuals whose addresses are outside the Greater New York City area. Many of these are to foreign borrowers. While roughly 47 percent of the loans are to businesses whose addresses are in the Greater New York area, excluding Long Island, it seems clear that many of these businesses properly should be classified as national or international businesses rather than as local New York businesses. The remainder, or approximately 14 percent of the loans, appear to be to borrowers from Long Island.

Since EAB made a conscious effort to select loans which would relate to FNB's Long Island and New York City base, the FDIC will be administering and collecting far fewer loans related to Long Island and New York City than were included in FNB's total loan portfolio the day it was closed.

As of January 31, 1975, the FDIC had collected approximately $113 million on the FNB assets it will be administering. These collections included payments of both principal and interest on outstanding loans and interest on securities and other assets. As of the same date, no sales of FNB assets from the FDIC portfolio had taken place. Expenses of the liquidation from October 8, 1974, through January 31, 1975, were approximately $2,316,000.

As of January 31, 1975, the FDIC had made directly or indirectly through EAB advances totalling $4,110,468 to 24 borrowers, on the grounds that such advances were necessary to protect assets. Applications for a few other advances are pending at the present time with the FDIC. Some applications for advances have been denied because they would not have enhanced the value of FNB assets being administered by FDIC and, thus, could not legally be made.

The FDIC has established its receivership offices at 50th and Third Avenue in New York City. Its mailing address and telephone numbers are:

Federal Deposit Insurance Corporation,
Receiver of Franklin National Bank
800 Third Avenue, 2d and 3d Floors
P. O. Box 1120
FDR Station
New York, New York 10022

Telephone: (212) 832-4284
(212) 832-4287

George W. Hill, Chief of the FDIC's Division of Liquidation, is the Liquidator-in-Charge of the FNB liquidation and W. Norman Davis, an experienced career employee of the FDIC Liquidation Division, is the Associate Liquidator. The liquidation office includes a full-time staff of approximately 80 employees, 50 of whom are experienced, professional liquidators and bank examiners. It is anticipated that the staff will ultimately total approximately 100.

In issuing this first report, FDIC Chairman Frank Wille said:

"In recent weeks, our receivership staff has been collecting and arranging up-to-date information on more than 6,000 Franklin assets for whose collection we, rather than European-American Bank & Trust Company, will be responsible. FDIC's policy in working out appropriate accommodations and collection schedules for FNB borrowers is to give individual consideration to each borrower's particular needs and problems. Our purpose is eventual collection, not precipitous hardship for FNB's former customers.

"As to the total recoveries likely on FNB assets in FDIC hands, it is still too early to make any reliable estimate. No such FNB assets have yet been sold and relatively few have to date been appraised. First estimates of possible recoveries from all the FNB assets in FDIC hands probably will not be completed until the end of 1975, and once made will undoubtedly be subject to significant change as our receivership progresses. Under our October 8 arrangements, all collections are to be applied first to FNB's indebtedness to the Federal Reserve System at the time of closing ($1,723,000,000 in principal amount), plus interest at a base rate of 7.52 percent per annum. These arrangements also require further payments to the Federal Reserve for collection expense reimbursement and additional interest in the event sufficient collections on FNB assets are realized. Only after these obligations to the Federal Reserve have been met and costs of liquidation have been recovered will other creditors of FNB, including capital noteholders, receive any distribution. Shareholders of FNB (and those who claim through such shareholders, like creditors of FNB's parent holding company) in turn rank below these other creditors of FNB in right of recovery.

"To avoid any duplication of collection effort and to keep the trustee in bankruptcy of FNB's parent company fully informed as to the value of his principal asset (FNB common stock), we have established liaison with him and are formalizing appropriate information procedures."

FDIC NEWS RELEASE

FEDERAL DEPOSIT INSURANCE CORPORATION

FDIC REPAYS $134 MILLION ON FRANKLIN NATIONAL BANK INDEBTEDNESS TO THE FEDERAL RESERVE

Chairman Frank Wille today announced that through the end of February 1975, the Federal Deposit Insurance Corporation had paid the Federal Reserve Bank of New York (FRBNY) a total of $134 million accrued from collections on Franklin National Bank assets being administered by the FDIC. These payments reduce the principal amount of the Corporation's indebtedness to FRBNY on account of Franklin National Bank's borrowings at the discount window at the time it failed from $1.723 billion to $1.589 billion.

The $1.723 billion was the full amount of Franklin National Bank's loan at the Federal Reserve discount window on October 8, 1974, the day the Comptroller of the Currency declared Franklin National Bank insolvent and named FDIC Receiver in accordance with the law. In connection with the subsequent purchase and assumption transaction arranged by the FDIC with European-American Bank & Trust Company, the FDIC assumed that secured indebtedness and entered into an agreement with FRBNY to pay off the full amount thereof within three years with interest at a base rate of 7.52 percent (the average rate of return on the System Open Market Account the same day) per annum. Under these arrangements, all FDIC payments to FRBNY are to be applied first to principal, with the interest accruing on the outstanding balance being payable at the expiration of the three years. The agreement between FRBNY and FDIC also provides for recovery by FRBNY of not more than $15 million in liquidation expenses which FDIC may be able to offset against such interest during the three-year period and for increased interest which would have the effect of raising the base rate to 8.5 percent per annum compounded annually, if (but only if) sufficient sums are collected by FDIC from Franklin National Bank assets to make these additional payments.

FDIC is administering Franklin National Bank assets which had an approximate book value of $2.1 billion on the day the bank closed. Periodic payments to FRBNY of interest, fees and principal amounts collected on these assets are required by the terms of the FRBNY-FDIC agreement (after reserving a portion of such collections for expenses and other costs incident to the collection process), although the first such payment is not due until early July 1975 (270 days after Franklin National Bank's closing).

If asset collections are insufficient within the three-year period set for repayment of the Federal Reserve loan, FDIC will advance the funds necessary for such repayment out of its gross revenues, now approaching $1 billion per year. In the unlikely event such revenues are insufficient for the purpose, the FDIC will draw from its accumulated trust fund, now approximately $6.2 billion, whatever portion of the final payment to FRBNY cannot be made from such gross revenues. Thereafter, FDIC will continue its efforts to

- more -

realize maximum value from the Franklin National Bank assets remaining in its hands, repaying the FDIC trust fund for the total amount of any such final payment to the Federal Reserve and for unreimbursed receivership expenses, plus a return of 6.5 percent per annum on the funds advanced for these purposes, with any remaining proceeds being applied for the benefit of other creditors, noteholders and shareholders of Franklin National Bank and its parent, Franklin New York Corporation.

FDIC NEWS RELEASE

FDIC ISSUES SECOND REPORT ON
FRANKLIN NATIONAL BANK RECEIVERSHIP

Chairman Frank Wille today released the second report on the Franklin National Bank Receivership being administered by the Federal Deposit Insurance Corporation, covering the period from February 1, 1975, through April 30, 1975. The first report, issued on February 25, 1975, covered the period from the closing of Franklin National Bank through January 31, 1975. These reports are part of the continuing effort by the FDIC to keep Congress, Franklin creditors and shareholders and the public at large fully informed as to the progress of the Receivership.

Following the receipt of competitive bids after the closing of Franklin National Bank ("FNB"), European-American Bank & Trust Company ("EAB"), won the right and has proceeded to select assets of FNB in an amount which will equal FNB's deposit and certain other liabilities assumed by EAB, less the amount bid by EAB. Unavoidable delays in the appraisal of certain real property has forced an extension of that settlement period, but the process should be completed by early June.

As of April 30, 1975, EAB had selected $1,461,758,700.00 of the $1,487,393,453.00 in assets it was required to select under the terms of the Purchase and Assumption Agreement, and had rejected $2,127,790,989.00 of the $2,170,945,575.00 in FNB assets it was required to reject. During the period February 1, 1975, through April 30, 1975, EAB selected $30,017,127.00, most of which were commercial loans, and rejected $40,124,912.00, most of which also were commercial loans. The pool of assets from which EAB will make its final selections totalled as of April 30, 1975, $70,683,450.00; any amount in the pool not selected by EAB will pass to the Receivership for FDIC administration.

The FDIC had collected as of April 30, 1975, approximately $288,185,977.00 on the FNB assets it was administering, $153,076,803.00 of which was collected during the period February 1, 1975, through April 30, 1975. These collections include payments of both principal and interest on outstanding loans and interest on securities and other assets as well as the sale of a few assets. Those assets which have been sold include, for example, American Swiss Credit Company, Ltd., a subsidiary of Franklin International Corporation, in turn a subsidiary of FNB, which was sold on March 31, 1975, for $34,134,593.15, $282,361.00 more than its FNB book value. In addition, the FDIC has begun an orderly liquidation of the FNB securities portfolio, a process which may take a number of years. During the three month period covered by this report, the Receivership sold by competitive bids $26,875,000.00 par value of these securities, carried on the books of FNB at $26,037,734.18, for $20,999,748.60, a loss from book value of $5,037,985.58. Had these securities been selected by EAB on October 8, 1974, or had the FDIC sold those same securities at that time, the estimated loss from book value would have been greater by $423,381.75.

As part of its liquidation policy and to provide assistance to those FNB borrowers whose loans are now being administered by the FDIC, the FDIC currently is developing a program by which those borrowers who wish can be put in touch with financial institutions and intermediaries capable of providing the continuing financing which the Receiver is unable to provide. The initial effort in this area will include the commercial banks in the Long Island Bankers Association and the mutual savings banks located in the Greater New York area.

Expenses of the liquidation from February 1, 1975, through April 30, 1975, totalled approximately $1,229,382.00, bringing the expenses of the liquidation from the commencement of the Receivership to approximately $3,545,382.00.

From the period February 1, 1975, through April 30, 1975, the FDIC made directly or indirectly through EAB advances totalling $3,899,269.00 on the grounds that such advances were necessary to protect assets. This brings the total advances made by the FDIC in this Receivership to $8,009,737.00 as of April 30, 1975, such advances having been made to 50 different borrowers. Applications for a few other advances are pending at the present time with the FDIC. During the period February 1, 1975, through April 30, 1975, some applications for advances were denied, as some were denied earlier, because they could not be justified as necessary to protect the value of FNB assets being administered by FDIC, the only proper basis for such advances.

From its collections through April 30, 1975, the FDIC has paid the Federal Reserve Bank of New York $228,472,054.79, reducing the principal amount due on the FNB "window" loan at the time of closing from $1,723,472,054.79 to $1,495,000,000.00. All of the payments have been made during the present three month period. Interest on the note will not be due until the note matures on October 8, 1977. Calculated on a base rate of 7.52 percent per annum, accruals of interest on this note through April 30, 1975, total $70,307,862.94. For the immediate future, the FDIC will continue to pay the Federal Reserve Bank of New York amounts collected in its liquidation efforts over a minimum working balance kept in the Receivership.

It remains too early to make any reliable estimate of the total recovery likely on FNB assets being administered by FDIC. The assets have not yet been appraised, and the task of marshaling the records on the approximately 6,000 FNB assets being administered by FDIC has not yet been completed. It seems at this time, as it did as of January 31, that first estimates of possible recoveries from all the FDIC-administered FNB assets probably will not be completed until the end of 1975, and once made will be subject to change as the Receivership progresses.

The Receivership remains a party to a number of lawsuits commenced prior to the failure of FNB. Additional suits have been filed since that time, both by and against the Receiver. In all cases, the policy of the FDIC continues to be one of vigorous litigation of its position, either as a plaintiff or as a defendant.

The FDIC continues to work with the trustee in bankruptcy of FNB's parent company, and together they are formalizing procedures by which such trustee receives advance notice of the sale of certain FNB assets.

While FDIC is making use of outside experts as needed in its liquidation activities, its own liquidation staff now totals 94 individuals, including liquidators, lawyers, examiners, auditors, former bank officers and clerical employees. The mailing address of the Receivership office remains the same, but the telephone numbers of that office have been changed since the first status report. The present address and telephone numbers of the Receivership office are:

FDIC FEDERAL DEPOSIT INSURANCE CORPORATION

NEWS RELEASE

United States National Bank

Statement by

Frank Wille, Chairman
Federal Deposit Insurance Corporation

before the

Subcommittee on Bank Supervision and Insurance
Committee on Banking and Currency
House of Representatives

November 27, 1973

This statement is in response to the Subcommittee's request for a discussion of the activities of the Federal Deposit Insurance Corporation incident to the transfer of certain assets and certain liabilities of the United States National Bank, San Diego, California ("USNB") to Crocker National Bank, San Francisco ("Crocker"). Based on the inquiries contained in your Chairman's letter dated November 12 and questions addressed to me during my recent appearance before the Subcommittee on November 5, my statement covers the following matters:

(1) FDIC's consideration of the alternative methods available to it to protect a bank's depositors and other creditors (pp. 6-11);

(2) Steps taken to insure that this particular transaction would be accomplished through competitive bidding (pp. 11-15);

(3) FDIC's position with respect to the demands for payment currently being made by holders of certain standby letters of credit issued by USNB, the majority of which are financial institutions located outside the United States (pp. 15-21);

(4) FDIC's involvement with USNB since its identification by the FDIC as a "problem" bank (pp. 21-33); and

(5) The current status of the USNB receivership (pp. 33-34).

I. GENERAL BACKGROUND

It would be useful in understanding this Statement to describe at the outset some of the basic elements of the "purchase and assumption" transaction that was entered into by FDIC, as Receiver of USNB, with Crocker National Bank. As you know, United States National Bank, an institution with approximately $1,265,868,000 in total assets and approximately $932,000,000 in deposits, was closed by the Comptroller of the Currency at 3:00 p.m., Pacific time, on Thursday, October 18, 1973. Pursuant to the applicable provisions of the Federal Deposit Insurance Act, the Comptroller of the Currency immediately appointed the FDIC Receiver of USNB. Approximately 300 FDIC examiners and liquidators thereupon took physical control of the 63 offices of USNB from 165 national bank examiners who had entered the bank prior to closing and, working throughout most of the night, these men and women verified the cash, collateral and safekeeping items held by USNB and supervised the closing out of the day's business.

While this was taking place, the three members of FDIC's Board of Directors (Frank Wille, Chairman; James E. Smith, the Comptroller of the Currency; and George A. LeMaistre, Director) were meeting in San Francisco where a call for bids pursuant to predrafted documents

was issued shortly after 3:00 p.m. Three envelopes submitted in response to this invitation to bid were received at 4:00 p.m., and were thereafter opened and analyzed. By 4:30 p.m., the FDIC had accepted Crocker National Bank's bid of $89.5 million, the highest bid submitted, and FDIC lawyers standing by in San Diego were instructed to proceed immediately to petition U. S. District Court Judge Neilsen, who had been previously assigned to the case, for the necessary court approval to the proposed transaction. After an ex parte hearing at which sworn testimony was received, the court approved the proposed purchase and assumption.

The entire transaction, together with all necessary approvals, was consummated by 6:15 p.m. -- only three hours and fifteen minutes after the largest bank failure in the nation's history. Friday morning all USNB's offices, except its Nassau, Bahamas office, reopened at their usual business hours as branches of Crocker National Bank.

In all, 335,000 depositors with almost $920 million in deposits, including 3,300 whose individual deposits exceeded the $20,000 insurance limit, and about 200 holders of other liabilities amounting to approximately $130 million were fully protected with no perceptible interruption whatsoever in banking service. It might be noted that because of FDIC's concern that banking services previously offered by USNB not be interrupted, the

purchase and assumption agreement required Crocker to keep open all banking premises of USNB, with the exception of the bank's branch in Nassau, for at least 30 days.

Under the terms of FDIC's agreement with Crocker, it was necessary for FDIC to advance to the Receiver $130 million in cash on October 19 so that the Receiver could make up the difference between the liabilities assumed by Crocker of approximately $1,070,000,000 and the USNB assets of approximately $850 million also transferred to Crocker, less its purchase premium of $89.5 million. An additional $30 million was paid by FDIC as Receiver to the Federal Reserve Bank of San Francisco to satisfy USNB's obligation to it, thereby obtaining for the receivership estate the release of assets which USNB had pledged to that Bank as collateral for the liquidity advances it had made. In addition, Crocker exercised the option it had under the FDIC's invitation to bid to place a five-year $50 million note with FDIC, at 7 1/2 percent per annum, an option designed to enable it to increase its capital account to support the very large increase in its liabilities which occurred by virtue of the purchase and assumption transaction. It is our understanding that this note will be retired whenever Crocker finds market conditions favorable for raising more permanent capital, but in no event later than October 22, 1978.

The Receiver's agreement with Crocker provided for the purchase by Crocker of all of the "clean" assets and liabilities of USNB. This included virtually all assets, deposits and other liabilities which were not related to USNB's control shareholder, Mr. C. Arnholt Smith, his business associates and their various affiliated interests. Because of the uncertain market value of such USNB assets as real estate, leased premises and the securities portfolio, these assets were transferred to Crocker at their book value subject to a later adjustment to reflect fair market value at the close of business October 18, 1973.

These provisions have left approximately $420 million in USNB assets at book value in FDIC's hands as Receiver, against which the following claims must be satisfied: an FDIC claim in the current amount of $160 million on account of cash advanced to the receivership estate, the claims of 39 holders of so-called "standby" letters of credit issued by USNB in the apparent aggregate amount of $91,268,222.98, the claims of approximately 120 Smith-related depositors who held aggregate deposits of approximately $8.8 million at the time the bank closed, the claims of future judgment creditors against USNB which cannot at this time be estimated as to amount, a number of miscellaneous claims of minor amount, and the claims of holders of USNB's subordinated capital notes and debentures (outstanding at the time of closing in the amount

of $14,750,000). The recoveries on these various claims will obviously depend on the collectibility of assets held by the Receiver and the final aggregate amount of proven claims against the receivership estate. For the special position in which the 39 holders of USNB's standby letters of credit find themselves, you are referred to the section of this Statement which begins on page 15.

In addition, FDIC has indemnified Crocker against all liabilities of USNB not specifically assumed under the purchase and assumption agreement and against any damages which might be assessed against Crocker as a result of the purchase and assumption transaction, other than those arising out of Crocker's own actions. Such an indemnity is standard FDIC procedure in purchase and assumption transactions, since judgments arising out of lawsuits not yet started when an insolvent bank closes, and other unknown claims against an insolvent bank, are not the type of risks an assuming bank is willing to accept.

With this background, I shall now respond to the more specific inquiries contained in your Chairman's letter of November 12, 1973.

II. ALTERNATIVES TO SEIZURE

FDIC has available to it three basic alternatives for dealing with an insured national bank which is in serious financial difficulty.

-- It can pay off the insured deposits up to the statutory ceiling of $20,000 and act as receiver in a subsequent

liquidation after the Comptroller of the Currency has declared the bank insolvent.

-- It can, where the necessary statutory findings can be made, undertake a program of direct financial assistance to such a bank in order to keep it operating.

-- It can, where the necessary statutory findings can be made, provide financial assistance to facilitate the bank's merger or consolidation with another insured bank, or to facilitate the purchase of assets and assumption of liabilities by another insured bank.

In the case of USNB, a payoff of insured deposits in a $1 billion bank with 63 offices and 335,000 depositors, in the judgment of the FDIC's Board of Directors, would have shaken public confidence in the nation's entire banking system, with especially severe repercussions in the State of California. This conclusion was supported by the California banks with whom we later spoke, who made it clear to us that a payoff of this magnitude was in their opinion "unthinkable." We anticipated for example that an insurance payoff would have necessitated an initial FDIC outlay of approximately $700 million and would have

resulted in an immediate loss of the use of approximately $230 million in depositors' funds to approximately 3,300 unsecured depositors whose deposits exceeded the $20,000 insurance limit (although in due course these depositors would undoubtedly have recovered some of this amount from liquidating dividends).

Considering such a payoff to be the very last resort after all the other alternatives had been discarded, we determined to explore completely the possibilities, within the framework of the Federal Deposit Insurance Act, of providing financial assistance to protect as many USNB depositors and creditors as possible as soon as we discovered that the failure of the bank was imminent.

Direct assistance to USNB was quickly rejected due to the FDIC's inability to force a change in USNB's ownership and the clear monetary benefit such direct assistance would have provided, at FDIC's expense, to the control shareholder and his associates who were responsible in the first instance for the bank's unsound condition. We also were unsure as to the amount of such financing that would be necessary to solve USNB's problems and were determined to avoid becoming involved in a continuing financial rescue effort that might extend over many years. It appeared, moreover, that a key finding required by the statute, i.e., that the continued operation of USNB was "essential to provide adequate

banking service in the community," could not be made and that the prospects of eventual repayment of any FDIC advance were speculative at best. Thus, we turned to the third alternative to determine if we could provide financial assistance for an acquisition transaction.

The statutory provision authorizing such assistance (Section 13(c) of the Federal Deposit Insurance Act) requires the Corporation's Board of Directors to determine that this course of action will "reduce the risk or avert a threatened loss to the Corporation" which FDIC would otherwise experience. Mindful of this statutory requirement, the Board, with the assistance of its staff, began to formulate the outline of a transaction which it hoped would permit the transfer of substantially all the banking business of USNB at a price sufficiently high to satisfy the basic statutory requirement that we reduce the financial risk to the Corporation which might occur in a payoff of USNB's depositors up to the $20,000 insurance limit. Throughout these early internal discussions, as well as our later negotiations with banks interested in a possible purchase and assumption transaction, we bore in mind the possibility that, if the acquisition did not command a sufficiently high price or "premium" we might still be required to utilize the undesirable payoff method. In the weeks before USNB closed, our Liquidation Division was not only assisting

us in formulating a purchase and assumption proposal, but was also formulating a contingency plan for a payoff, including preparing the blank checks and checkwriters for transportation to California. Moreover, preparation for a possible payoff was needed in any event since, having early determined that competitive bidding rather than a negotiated sale with one bank would be most likely to yield the greatest premium, we also recognized that we would not know until after USNB had closed and the bids were opened whether we had obtained a premium sufficient to meet the statutory standards.

As we were formulating our initial outline of a transaction in late August and early September, we began to receive additional information from the Comptroller's Office and from the larger California banks we approached which influenced our thinking. Thus, we learned that USNB's management was itself trying to arrange a statutory merger or consolidation with other banks which had looked over its books and records. We also received, in preliminary form, the results of the Comptroller's special examination of the Smith-related credits which began in July 1973. From our discussions related to these two matters, we concluded that none of the banks likely to be interested in acquiring USNB would be willing to or, for that matter, could do so without significant FDIC assistance. Among other factors, the questionable value of many of

the Smith-related loans meant that they could not simply be transferred to another bank without substantial risk to the acquiring bank. The only arrangement under which the acquiring bank could be expected to accept these assets at book value would be under some form of FDIC guarantee against loss.

III. EFFORTS TO INSURE COMPETITIVE BIDDING

Against this background, serious discussions were begun with Wells Fargo Bank, N. A., Crocker National Bank and Bank of California, N. A., in early September. All three of these banks had expressed interest in acquiring USNB's offices and most of its banking relationships and each was regarded as having sufficient size and management capabilities to take over the operations of a billion dollar bank and 63 offices. Furthermore, none of the three was heavily concentrated in the five counties of Southern California where USNB had branches, or in San Diego County, where USNB's share of the market was the most significant. Our General Counsel and members of his staff, together with local California counsel retained by the FDIC and lawyers assigned by the Comptroller of the Currency, began direct negotiations with the three banks and their counsel in San Francisco to determine if a purchase and assumption agreement satisfactory to all three banks and the FDIC could be drafted.

We were apprehensive, however, that if we limited our negotiations to only three banks, when we had no certainty that all three would stay in the bidding until the end, we would not be able to obtain the highest bid possible. We therefore desired to expand the number of banks that might be interested in bidding. Three of the four other California banks able to assume $1 billion of liabilities -- Bank of America, NT&SA, Security Pacific National Bank, and United California Bank -- all seemed to present serious antitrust problems. Accordingly, on September 24, prior to entering into discussions with any of these three banks, we solicited the views of the Antitrust Division of the Department of Justice. It was the Division's view that under the Bank Merger Act even an emergency purchase and assumption could be effected with Bank of America or Security Pacific only if there was no other reasonably acceptable alternative. United California Bank posed less of an anti-competitive problem than these two banks, according to the Antitrust Division, but it was sufficiently strong in Southern California to be a less desirable alternative than the three banks with whom we had already had extended discussions. The FDIC's General Counsel and I, together with the Regional Administrator of National Banks in San Francisco, thereupon promptly held discussions with each of these banks, with a full disclosure of the Justice Department's view of their respective

competitive positions. United California Bank considered the matter carefully but determined not to pursue the discussions further. Bank of America and Security Pacific National Bank, recognizing their anti-trust disadvantages, did not participate actively but agreed as a matter of public service to stand "waiting in the wings" to be contacted immediately if no acceptable bid were obtained from some other source.

In the interest of covering all the major California banks, we also contacted Union Bank, Los Angeles, late in September, and it became an active participant in the drafting discussions. We had not previously discussed the matter with Union Bank even though it did not appear to present any anticompetitive problems because we erroneously believed it would not be interested in view of its well-known orientation as a wholesale, rather than a retail, bank.

In addition, in early October a group of private investors with access to substantial funds and bank management capabilities approached the Comptroller of the Currency and FDIC and expressed interest in purchasing USNB's banking business and offices. After full disclosure of the relevant facts to this group, it determined not to participate further in the discussions then being held with the major California banks.

From time to time fundamentals of the purchase and assumption transaction felt to be desirable by the FDIC or by one or more of the

interested banks threatened to drive other banks out of the bidding group. In each such instance FDIC sought that common denominator which would keep the greatest number of potential bidders interested. While it is impossible to state the likely outcome of alternative approaches, it appeared to us on October 18 that the successful bid of $89,500,000 was substantially above the purchase price we would have received had we not kept as many potential bidders as interested as we did and substantially above the purchase price we would have received had we attempted a negotiated sale with only one of the interested banks.

The final package developed was, of course, the "clean bank" package which would convey only assets and liabilities of determinable value, i.e., excluding virtually all assets and liabilities related to the controlling shareholder, his business associates and their affiliated interests. Under such a package, FDIC as Receiver would retain responsibility for working out such Smith-related assets and liabilities. This, we believed, was in the best interests of both FDIC and the bidding banks, for to have transferred a portion (presumably the best portion) of the Smith-related loans and liabilities would have had, in our opinion, serious adverse consequences to the receivership and to other claimants. For example, many of the companies involved may be responsible, through cross-guarantees and by benefits received, for the loans of

other Smith-related companies. Also, we would have found ourselves, in the collection process, competing with the assuming bank for the same Smith-related assets. Furthermore, given the many hundreds of Smith-related transactions involved, it would have been impossible to sort out the "acceptable" portion of the $420 million in Smith-related loans and other assets in the few weeks available to us before the transaction.

IV. THE "STANDBY" LETTERS OF CREDIT

At the time of its closing, USNB showed on its books obligations in an amount in excess of $100 million on account of certain "letters of credit" it had issued. Some of these were traditional letters of credit secured by title documents against goods in transit or yet to be shipped. Such letters of credit were required to be assumed by Crocker under the purchase and assumption agreement which it entered into with the Receiver.

However, approximately $91 million in letters of credit, representing over 70 transactions, appeared on the bank's records to have been issued to guarantee a primary obligation of one or another Smith-related enterprise or affiliated person. We assumed, because of the manner in which these transactions were booked by USNB (i.e., as contingent liabilities not required to be included on its balance sheet) and because of statements made to us by certain USNB officers, that

these "standby" or "guaranty" letters of credit had been issued to guarantee the payment of loans either made directly to Smith-related interests by the 39 holders of such letters of credit or purchased by them from USNB directly or through brokers. Most of these letters of credit carried maturity dates well beyond October 16, 1973.

As previously stated, we had earlier determined that the "clean bank" to be sold by the Receiver to a successful bidder would not include any Smith-related assets or liabilities. The $91 million of letters of credit referred to in the preceding paragraph appeared to fall directly into this category and to be intimately connected with other Smith-related credits being retained for work-out in the receivership. Also, the loans underlying the letters of credit were of questionable quality and we were uncertain whether all such letters of credit were actually reflected on USNB's books and records. Because of this, we could not be certain that the $91 million indicated was the maximum amount of claims in this category that might ultimately be presented against the receivership or whether the underlying USNB asset (the account party's obligation to the bank) would equal the liability on the letter of credit. Furthermore, the FDIC Board of Directors was adviced by counsel that under various court decisions, the claim of a beneficiary under a "guaranty" letter of credit which had not matured

at the time of a bank's insolvency might not be a provable claim against the receivership. To have required Crocker to assume these letters of credit automatically, with an additional advance or guaranty from the FDIC of $91 million or more, could have subjected the FDIC, under the facts known to us at the time of closing, to criticism from the public, from other creditors, and from minority shareholders. You can, of course, appreciate that other creditors of the receivership, including subordinated noteholders and shareholders, are not likely to stay silent for long if the Receiver makes payments out of receivership assets for claims which are not legal obligations of the receivership estate. Accordingly, as USNB's liability on these letters of credit was likely to be a matter of complex litigation involving all the Smith-related assets and liabilities, we determined that the most feasible course was to retain these apparently contingent and unmatured obligations in the receivership. We believed it far preferable to require an individual proof of claim which would allow the Receiver full opportunity to determine the facts of each particular letter of credit transaction.

Several developments since the closing of the bank have raised additional questions in respect of these letters of credit, $76 million of which appear to be held by 24 foreign banks in varying amounts. Within days after October 18, several foreign bank beneficiaries of these letters

of credit notified us that their claims were based not upon a "guaranty" by the bank of an obligation of a third party, but rather that they had placed normal Eurodollar loans or deposits directly with USNB and had no knowledge of or relationship with the underlying borrower or account party specified in the letter of credit. Further, through information obtained from former employees of the bank, it became apparent that all of the records pertaining to these letters of credit were not available to us in the bank's offices but rather were being held in C. Arnholt Smith's personal office in San Diego, an office which was not considered part of the bank's premises and to which FDIC liquidators had previously been denied access. We advised the Chief Assistant U. S. Attorney in San Diego of our knowledge of this fact, and after required court proceedings, a search warrant was issued on November 8, 1973 by a magistrate and executed the next day by the FBI. As a result of this search, over 700 files relating to various letter of credit transactions were discovered. Copies of these documents were requested and immediately provided to us by the Chief Assistant U. S. Attorney. In addition, FDIC has issued subpoenas to certain former bank officers and employees, and to employees of some of the Smith-related companies, to produce records relating to these letter of credit transactions, as well as other bank transactions. These subpoenas have already produced access to many

additional cartons of records relating to letters of credit and other USNB transactions, and our legal staff is presently examining them.

To the extent that these records, when combined with the documentation and other proof of claim submitted by a particular letter of credit holder, show that the relevant transaction was improperly booked by the bank, and thus listed on a schedule of obligations to be retained by the Receiver instead of as a deposit or other liability scheduled to be assumed by Crocker, a correction will be made as required by the purchase and assumption agreement, and the liability will be assumed by Crocker against matching cash or an appropriate guaranty from the Receiver. All other claims of letter of credit holders will be processed in the normal course and, if provable against the receivership, will be entitled to ratable dividends along with other creditors as and when such dividends are declared. If there is a dispute between the Receiver and the beneficiary as to the provability or amount of such claims, the issues presented will, of course, have to be decided in the courts.

Needless to say, any allegation that the structure of the purchase and assumption transaction was designed to prejudice foreign, as against domestic, creditors of USNB is totally without foundation. Such a course of action was at no time even suggested by any participant in the negotiations leading up to the purchase and assumption transaction, and there

are in fact domestic as well as foreign holders of these letters of credit. Actually, some of the banks with whom we engaged in negotiations prior to October 18 believed that the purchase and assumption transaction should cover these letters of credit, whether or not the Receiver might be legally liable for their payment, just because the majority of beneficiaries appeared to be foreign banks. We rejected this approach for the reasons previously stated.

While some of the foreign bank beneficiaries of these letters of credit are understandably concerned about the prospects of repayment, we have made it very clear to their principal spokesmen, at meetings here in Washington on November 9 and November 26 and in a cable I sent to the General Manager of National Westminster Bank Limited on November 21, that if upon review of all the facts, including the documentation in their possession, it appears that a letter of credit they hold merely evidences a direct interbank loan or deposit made in the normal course of business, as many of them are now claiming, it will be assumed by Crocker under the purchase and assumption agreement, and we will, of course, honor our commitment to Crocker to advance any additional funds or guaranties that may be necessary for this purpose. Our position on this complex and difficult issue has not changed in any way by virtue of the class action suit filed against us on November 21 on behalf of the

holders of these "guaranty" letters of credit alleging, in substance, that as to them the entire purchase and assumption transaction was in contravention of applicable statutes and requesting, among other things, that FDIC and Crocker be enjoined from carrying out the terms of our agreement. FDIC intends to contest that litigation vigorously, but we will at the same time review expeditiously, as we have repeatedly assured these holders we would, any proof of claim or documentary evidence filed by them with us in order to determine the standing of their claims. Advice as to the appropriate method of filing these claims and the supporting documentation was sent to each holder of record of these letters of credit immediately after USNB was closed and repeated at numerous meetings in San Diego and at the Washington meetings of November 9 and November 26, as well as in my cable of November 21. As of November 23, only eight holders of these letters of credit had filed such claims with the Receiver.

V. FDIC'S INVOLVEMENT WITH USNB SINCE ITS IDENTIFICATION AS A "PROBLEM" BANK

In your Chairman's November 12 letter regarding my appearance before this Subcommittee, he requested a summary of the "supervisory steps" taken by FDIC from the time United States National Bank first came to our attention as a "problem" bank. At this point a brief description of

the statutory framework for the regulation of national banks and the place of FDIC within that framework appears necessary.

The primary function of FDIC with respect to an insured national bank is that of an insurer of the bank's deposits. It is not, with respect to national banks, a supervisory or regulatory body. Thus, even when a national bank is in financial difficulty, FDIC's role has been carefully limited by the Congress.

For example, under Section 10(b) of the Federal Deposit Insurance Act, Congress conferred upon FDIC the power to conduct a special examination of a national bank if "in the judgment of the [FDIC] Board of Directors such special examination is necessary to determine the condition of any such bank for insurance purposes" (emphasis added). The legislative history of the 1950 amendment to this section indicates that FDIC's power to examine national banks was intended to be exercised with great restraint. Indeed, based on concern expressed in this regard by some members of Congress, there was incorporated in the legislative history a letter from the then FDIC Chairman Harl to Senator Maybank, then Chairman of the Senate Committee on Banking and Finance, which stressed that FDIC would not exercise its examination powers merely to duplicate examinations conducted by national bank examiners. As my later testimony will indicate, from the time FDIC first began to learn

the extent of the serious financial difficulties facing USNB, the bank was under almost constant surveillance and examination by the Office of the Comptroller of the Currency. Further, throughout this period, FDIC was receiving information regarding USNB's problems from the Comptroller's Office. Based on this flow of information, FDIC did not believe that an independent examination by its examiners was necessary, or that any useful purpose would be served by having a second team of examiners go over the same ground the Comptroller's examiners were already covering.

It should be noted, however, that in the last few weeks before USNB was closed, and when the structure of the purchase and assumption transaction was beginning to take shape, six FDIC employees went to San Diego for the purpose of obtaining specific and detailed financial information to be utilized in discussions with banks interested in acquiring USNB's offices and banking business and to gather data to be used in the preparation of the schedules which had to be attached to the purchase and assumption agreement. These FDIC personnel obtained the information they needed primarily through requests made of national bank examiners then in the bank.

FDIC also has the power under Section 8(a) of the Federal Deposit Insurance Act to terminate a national bank's status as an insured bank. However, as I am sure this Subcommittee is aware, a formal proceeding

to terminate insurance is a long, drawn-out and complicated procedural affair which requires at least one year to complete. Also, the corrective action which FDIC can secure under Section 8(a) is similar to the corrective action the Comptroller of the Currency can order a national bank to take under the Financial Institutions Supervisory Act and which the Comptroller did in fact order USNB to take in May 1973.

Under Section 7 of the Federal Deposit Insurance Act, FDIC has access to the Comptroller's examination reports on national banks. For many years we have had an arrangement for the cooperative exchange of information with his Office, so that we may review these reports in order to measure our insurance risk.

Since national banks included on the Comptroller's list of banks in need of special supervision are those most likely to present the greatest potential of financial risk to the federal deposit insurance fund, FDIC is automatically provided all reports of examination of these banks. Other national bank examination reports are made available to FDIC upon specific request. Review of such national bank reports of examination is made on a random sampling basis so FDIC may be informed as to their condition on a more current basis. Under this program about 15 percent of the examination reports of national banks are reviewed annually.

Where circumstances warrant, the bank is accorded problem bank status by FDIC's Division of Bank Supervision and a written analysis of the situation summarizing the specific difficulties, contributing factors, and corrective action being taken by the Comptroller of the Currency is prepared for the information of FDIC officials. A copy of this analysis is also provided to the Comptroller's Office.

FDIC utilizes three categories of problem banks. The most stringent of these is designated "Serious Problem -- PPO" (Potential Payoff), which is assigned when a bank is considered to present at least a 50 percent chance of requiring financial assistance from FDIC in the near future. Next in severity is the "Serious Problem" status which includes banks which threaten ultimately to involve the Corporation in a financial outlay unless drastic changes can be brought about. Finally, banks which have not deteriorated to a point where assignment of one of the two foregoing categories is in order, but nonetheless have substantial weaknesses requiring prompt corrective action are designated "Other Problem." Generally, elements which cause a bank to be classified as a problem include, among other things, a rapid rate of asset deterioration, an extraordinarily low adjusted capital position, pronounced management deficiencies, or other adverse factors.

In the case of USNB, the reports received prior to the report of the June 1972 examination gave no cause for alarm and the bank was not classified as a "problem" bank. Then, in late October 1972 FDIC received a copy of the June 26, 1972 Examination Report of USNB, the so-called Martin I Report (based on the name of the national bank examiner in charge of the examination which was completed on September 12, 1972). On November 9, 1972, after a review of the Martin I Report, FDIC's supervisory staff classified the bank as a "serious problem." Classified assets had risen from 25 percent of capital and reserves as of the September 13, 1971 examination to 371 percent of capital and reserves as of June 26, 1972; 86 percent of the classified assets were obligations of business entities which C. Arnholt Smith and his family and business associates controlled; and standby letters of credit totalling $113,000,000 had been issued in favor of these entities. The majority of the classified assets were in the "substandard" category -- the least serious of three adverse classifications, the other two classifications being "loss" and "doubtful."*/ Thus, the Martin I Report did not indicate that there was

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*/ It is generally assumed that assets classified "loss" are virtually uncollectible, those classified "doubtful" are, on the average, 50 percent collectible and those classified "substandard" are in need of aggressive management servicing and attention to prevent further deterioration and potential losses.

immediate concern for USNB's solvency, although a severe liquidity strain appeared possible if USNB were forced to fund its standby letters of credit. This report also noted, for the first time, that C. Arnholt Smith had deliberately concealed credit information relating to the classified loans in order to hide their true quality.

At about this same time the Washington Office of FDIC began to receive reports from some of its Regional Directors indicating that they had discovered USNB letters of credit issued to guarantee loans made to Smith-related companies in State nonmember banks examined by FDIC. In some cases these loans amounted to alarmingly high percentages of the capital and reserves of the nonmember banks in question. As a result of further investigation, FDIC determined that USNB, working through a broker, had sold these Smith-related loans, attaching its letter of credit as a "guaranty" of their payment, to many banks and other financial institutions.

Members of the FDIC's staff immediately began consultations with their counterparts in the Office of the Comptroller of the Currency to determine what supervisory steps were being taken with regard to USNB and in order to be kept advised of its financial condition. Of primary concern in these consultations was USNB's liquidity position. At that time, FDIC was advised that the Comptroller of the Currency's Office

planned to examine the bank again in early January 1973 and this examination was commenced during the first week of January 1973.

During January and February we also became aware of the investigation by the Securities and Exchange Commission into the C. Arnholt Smith empire. No details of that investigation were then available to us except that USNB was "involved."

In late April of 1973 various members of the FDIC and Comptroller's staffs were invited to attend a meeting called by the staff of the SEC's Enforcement Division. At that meeting the SEC's staff advised those present that it had concluded an investigation of Mr. Smith and the various companies controlled by him, including USNB. As a result of the investigation, which was based in part on information made available to the SEC by the Comptroller's Office from the January 5, 1973 examination of USNB, the SEC's staff had found that USNB was heavily involved in various allegedly fraudulent transactions and that as a result of these transactions the value of the Smith-related loan portfolio was extremely questionable, more questionable even than the Comptroller's June 1972 Examination Report had indicated. The SEC's staff further advised that it was considering requesting an "equity receivership" for both USNB and Westgate California Corporation, a major Smith-controlled affiliate, in order to protect minority shareholders. The SEC's staff

invited the Comptroller's Office, as the bank's supervisory authority, and FDIC, as insurer of the bank's deposits, to comment on what they believed would be the effect of the proposed court action and whether, in their judgment, the proposed action was contrary to the public interest or in conflict with their regulatory responsibilities.

The representatives of the banking agencies at this meeting advised the SEC's staff that naming USNB as a party to or as a conspirator in the proposed fraud action might cause a run on the bank and frustrate the possibilities of an orderly transfer of its assets and liabilities to another insured bank. There was also an extended discussion of whether the SEC or the court had any legal authority to appoint an equity receiver for a national bank and whether the SEC's enforcement objectives could be attained without naming the bank as a party or as a conspirator. In this regard, the FDIC staff suggested that the SEC should, in order to balance the protection of depositors and other creditors with the rights of minority shareholders, distinguish between USNB as an institution and those persons who involved the bank in the allegedly fraudulent transactions; that, in other words, the prevention of future fraudulent activity could be accomplished even if the bank were not named as a defendant or conspirator. Further, it was pointed out that the Comptroller's Office could force the

responsible wrongdoers out of the bank's management without an equity receivership. At this meeting, the Comptroller's representatives advised those present that he was considering issuing a cease-and desist order against USNB and that his Office had discussed the possibility of a consent order with C. Arnholt Smith. As you know, the Comptroller issued such an order on May 24, 1973. That order required, among other things, that C. Arnholt Smith resign as an officer and director of USNB.

In a letter to the SEC dated May 10, 1973 the Acting Comptroller of the Currency asked for an opportunity to review and comment, prior to its release, upon the contents of any court complaint or public announcement proposed to be issued by the SEC which might name USNB as a party in an SEC fraud action. A second letter on this same matter was sent to the SEC by the Acting Comptroller of the Currency on May 25, 1973. Both letters identified the harmful consequences which, in the Acting Comptroller's judgment, could follow the naming of the bank in an SEC fraud action.

I authorized the Acting Comptroller of the Currency to state, in his letter of May 25, that I concurred with the statements he made in both letters concerning the potentially harmful consequences of naming USNB as a party or as a conspirator and concerning the appropriateness

of permitting the Comptroller of the Currency to deal with USNB's management and asset problems without the filing of an SEC lawsuit naming the bank as a party. The SEC apparently concurred in this view, for subsequent to the receipt of these letters, the SEC did authorize the filing of a fraud action against Westgate California, C. Arnholt Smith and others, but the bank was not named as a party to the action.

In early May the results of the January 1973 examination were received by FDIC in preliminary and abbreviated form. Based primarily on this information and its evaluation by both the Comptroller and the SEC, FDIC continued USNB's designation as a "serious problem" and added the designation "potential payoff."

In mid-July 1973 FDIC received a complete copy of the report of the January 5, 1973 examination of USNB (the so-called Martin II Report). At that time FDIC's review examiners indicated that the classified assets were almost 300 percent of the bank's capital and reserve accounts. More alarming, however, was the fact that during this examination the asset classifications assigned were substantially more adverse than in the previous examination. Many of the Smith-related loans were classified as loss or doubtful rather than as substandard, as in the prior examination.

Throughout the period May to mid-July 1973 FDIC's major concern was USNB's liquidity condition and the arrangements being made to improve that condition. During June the liquidity problem worsened and the Federal Reserve Bank of San Francisco was drawn into discussions attended by FDIC personnel, at which meetings it was agreed that the Federal Reserve Bank would provide the immediate liquidity needs of USNB.

Discussions continued in July both in San Francisco and Washington among officials of all three Federal banking agencies concerning USNB's liquidity and a long-run solution to USNB's problems. The Federal Reserve Bank of San Francisco continued its short-term advances. As I noted earlier, during this period there were preliminary discussions between USNB's management, the Comptroller's Office and interested banks looking toward a deposit assumption transaction without FDIC assistance. Also, a re-examination of the entire range of Smith-related credits was begun in July.

In late August 1973 Comptroller of the Currency Smith requested a joint meeting with representatives of the FDIC and the Federal Reserve Board. At that time the Comptroller advised FDIC of the preliminary findings of the limited July examination. The Comptroller also indicated that it was his opinion, based on the most recent examination, that in the very near future insolvency was probable and that there was little

possibility of a takeover by another bank without financial assistance by FDIC. Subsequent to that meeting, FDIC began actively to consider the alternative courses of action available under the Federal Deposit Insurance Act, and ultimately put together the transaction which resulted in Crocker's purchase of designated USNB assets and its assumption of designated USNB liabilities.

VI. CURRENT STATUS OF THE USNB RECEIVERSHIP

I would also like to summarize for you the current status of our liquidation efforts.

FDIC as Receiver is now completing an inventory of the USNB assets assumed by Crocker which are subject to price adjustment during a 210-day settlement period in accordance with the purchase and assumption agreement. This has required separating from USNB's records those files and documents associated with Smith-related loans. Approximately 50 FDIC employees are involved in this process and virtually every relevant document must be inventoried, read and analyzed. Physical assets such as the approximately 20,000 items of furniture and fixtures spread throughout USNB's 63 domestic locations must be located; leases on 33 branches must be analyzed; and the ownership status of the remaining branches must be determined. At present, the receivership has acquired 2,774 assets aggregating more than $420 million in book value,

including charged off loans of $6.7 million. This task has been made more difficult by the discovery that records of many transactions were not located on USNB's premises. As I previously indicated, FDIC is using its subpoena powers to recover as many of these records as possible. Further, at the time of closing, there were more than 150 lawsuits by or against USNB relating to its normal banking activities and FDIC as Receiver is in the process of assuming control of those lawsuits.

The liquidation is proceeding in an orderly manner and additional information is being developed daily. Our representatives have been in contact with the majority of debtors and creditors of the receivership and are proceeding to assist debtors in their current problems and to advise creditors of the requirements for filing relevant claims. I would anticipate being able to provide the Congress with more complete information as to the status of the receivership periodically in the future.

FDIC
FEDERAL DEPOSIT INSURANCE CORPORATION

NEWS RELEASE

Status Report to the Congress on the Receivership of
United States National Bank

Statement by

Frank Wille, Chairman
Federal Deposit Insurance Corporation

before the

Subcommittee on Bank Supervision and Insurance
Committee on Banking and Currency
House of Representatives

December 12, 1974

INTRODUCTION

This statement is in response to the Subcommittee's request for a current status report of the receivership of the United States National Bank, San Diego, California ("USNB") and supplements the initial report I gave the Subcommittee a year ago. The receivership is, of course, still in progress and the bottom line of FDIC's collection efforts will not be known for many years. Even with that caveat, however, it appears likely that this one failure will result in a final net loss to the federal deposit insurance fund substantially greater than the aggregate of all losses resulting from the failure of all other FDIC-insured banks since 1933. */

USNB was declared insolvent by the Comptroller of the Currency on October 18, 1973, and the Federal Deposit Insurance Corporation was immediately appointed Receiver thereof pursuant to law. Under the terms of the Purchase and Assumption Agreement entered into on the same date (the "Agreement") between FDIC, as Receiver, and Crocker National Bank, San Francisco, California ("Crocker"), Crocker

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*/ From January 1, 1934, to date, 506 FDIC-insured banks have closed, including USNB and Franklin National Bank, New York. This statement assumes a final net loss to the federal deposit insurance fund of approximately $75 million for the 501 bank failures prior to USNB and a significantly smaller figure for the 4 bank failures that have occurred so far in 1974.

was required to assume virtually all of USNB's deposits and other non-subordinated balance sheet liabilities (other than a secured $30 million "window" loan from the Federal Reserve Bank of San Francisco to USNB which the Receiver paid in full prior to consummation of the Agreement) and to purchase in exchange offsetting assets less the $89.5 million price it bid for the overall transaction. Excluded from the transaction, however, for the reasons stated in my testimony last year, were all assets, deposits and other liabilities related to USNB's control shareholder, Mr. C. Arnholt Smith, his business associates and their various affiliated interests (referred to in the Agreement as the "Designated Group"). The FDIC as Receiver in turn retained responsibility for working out such Smith-related assets and liabilities, and since this arrangement produced a substantial shortfall in the USNB assets which Crocker could acquire to offset the USNB liabilities it assumed, FDIC as Receiver agreed to make up any such shortfall in cash. The Agreement also provided that Crocker could return to FDIC as Receiver up to $15 million in non-Smith-related loans for any reason and receive cash therefor in a corresponding amount.

Under this Agreement, with all figures reflecting post-closing adjustments made to date, Crocker assumed the liability to pay approximately $924 million in USNB deposits and approximately $201 million

in other USNB nonsubordinated balance sheet liabilities, including standby letters of credit issued by USNB aggregating $47.7 million in principal amount which FDIC as Receiver determined in June of this year represented direct interbank loans or deposits between the original holder of the letter and USNB. Crocker has received offsetting assets of approximately $1,036,000,000 consisting of: USNB cash and due from banks of approximately $121 million, non-Smith-related loans of approximately $265 million, securities worth $331 million, bank premises and equipment appraised at approximately $20 million, other USNB assets of approximately $18 million and balancing cash from the Receiver of approximately $281 million.

Under the FDIC's invitation to bid on the Agreement, Crocker or its parent holding company was also given an option to place a five-year $50 million note with FDIC in its corporate capacity, at 7 1/2 percent per annum. This option, which was promptly exercised, was designed to enable the successful bidder to increase its capital account immediately upon consummation of the Agreement so as to support the very large expansion in its deposit liabilities which would occur by virtue of the purchase and assumption transaction. The note issued by Crocker's parent is to be retired whenever Crocker finds market conditions favorable for raising more permanent capital, but in no event later than October 22, 1978.

For convenience, the balance of this statement is divided into five sections:

I. FDIC's Cash Advances to date and the Sources of Repayment

II. Current Status of Certain USNB Standby Letters of Credit

III. An Overview of FDIC's Collection Efforts

IV. A Specific Example: Westgate-California Corporation

V. Litigation By and Against the Receivership Estate

I. FDIC's Cash Advances to date and the Sources of Repayment

The FDIC Board of Directors to date has authorized cash advances from the federal deposit insurance fund of approximately $372 million in connection with the USNB failure. Fifty million dollars of this total amount represents a direct obligation of Crocker National Corporation on account of the 7 1/2 percent five-year note it issued to FDIC last October in order to increase Crocker's capital accounts by a like amount. FDIC expects repayment in full of this amount not later than October 22, 1978. The remaining $322 million has been advanced to the receivership estate to provide: the $281 million in cash needed by Crocker to balance the liabilities it assumed, the $30 million necessary to pay off the window loan which the Federal Reserve Bank of San Francisco had extended to USNB as of the time of closing, approximately $9 million subsequent to USNB's closing to protect

receivership assets and the balance for a variety of miscellaneous settlement adjustments required by the Agreement and for certain liquidation expenses. As of last Friday, December 6, 1974, the Receiver had collected about $28 million on receivership assets and had repaid about $19 million to the insurance fund. Thus, the balance owing from the receivership estate to the federal deposit insurance fund now stands at slightly more than $300 million.

To repay this $300 million, the Receiver currently holds USNB assets having an approximate book value, net of realized losses, of $438 million. In addition, there are unbooked claims on which the Receiver may be able to realize significant amounts, such as its claims for fidelity losses under USNB's blanket bond and its litigation against former USNB directors.

The book value figure of $438 million in receivership assets is misleading, however, since it reflects USNB's least attractive and least collectible assets. About $345 million of this total represents indebtedness in one form or another of Smith-related borrowers, while the balance includes such items as undesirable non-Smith-related loans returned by Crocker, loans charged off or assets not booked by USNB prior to its closing, municipal securities for which there is no ready market, foreign time and demand deposits which have been offset

against unpaid letters of credit, prepaid USNB expenses of little value to the Receiver, and long-term purchase obligations held in connection with the sale of borrowers' assets. While many of these receivership assets have some value, we currently estimate aggregate recoveries far below not only the book value of these assets, but far below the remaining $300 million in FDIC advances to the receivership estate.

Last January, based on developments in the receivership through year-end 1973 and our very preliminary appraisals of the assets then held, the FDIC Board of Directors established a reserve for loss on account of the USNB receivership of $48.3 million. Subsequent events, including the payment of $47.7 million in disputed letter of credit claims and the return by Crocker of approximately $35 million in Designated Group loans not previously identified as such, with the resulting receipt of assets in exchange which added little in value to the Receiver's anticipated recoveries, indicate that a substantial addition to this reserve will be required at the end of January 1975 based on developments in the receivership through this coming year-end. While it is premature to estimate the addition to last year's reserve which the FDIC Board of Directors will consider appropriate under all the circumstances, it is likely to fall between $50 million and $100 million. Whatever the total reserve established, it will be subject to further

adjustments in the years ahead as more accurate appraisals become possible on both the asset and liability side of the receivership's books. As the existence of any FDIC reserve for loss would imply, I see little chance of recovery even in part for USNB shareholders or debenture holders unless they succeed in overturning their subordinated status or in making recoveries from former USNB officers and directors through litigation.

II. Current Status of Certain USNB Standby Letters of Credit

In my testimony before this Subcommittee last November, I reviewed for you FDIC's position and the actions taken by FDIC up to that time with regard to certain standby letters of credit issued by USNB. In brief, prior to its closing last October, USNB had outstanding letters of credit in the principal amount of approximately $91.3 million which were carried on its books as standby letters of credit issued to guarantee the obligations of account parties affiliated with or closely related to C. Arnholt Smith, the so-called "Designated Group." Because these letters of credit, and the related obligation of the account party, appeared to be among USNB's Smith-related assets and liabilities, they were retained in the receivership. Shortly after USNB was closed, a number of the 39 holders of these retained letters of credit advised FDIC that, in their opinion, the obligations evidenced thereby were not USNB

guarantees of customer loans, but rather USNB direct obligations for deposits in or loans to USNB by the holder. FDIC thereupon asked each of the holders of these standby letters of credit to file a proof of claim outlining its version of the transaction, and by January 1974 virtually all of them had filed detailed claims. I also advised you that FDIC itself was in the process of conducting an extensive investigation into the facts underlying the issuance of these standby letters of credit.

Between January when all known records were gathered and June 1974, the FDIC staff reviewed each claim to determine whether the letter of credit issued by USNB represented USNB's guarantee of an obligation due from the account party to the beneficiary, as FDIC at first believed and as USNB's records indicated, or whether it evidenced a direct deposit or loan transaction between USNB and the beneficiary as many of the holders claimed. To make this determination, the FDIC staff relied on information obtained from interviews with brokers, former USNB officers and account party officers, as well as all of the documentation surrounding the transactions, including the files of USNB, the files kept in C. Arnholt Smith's private offices (which frequently contained information different from that found in USNB's files), and correspondence among USNB, the beneficiaries, the account parties and the brokers. Where available, records of the account parties were also reviewed. Many of the letters of credit which were outstanding at

the time USNB closed appeared to evidence transactions which were rollovers of prior transactions between USNB and the beneficiaries. In order to determine the initial intention of the parties at the time transactions between them were first begun, it was necessary to review not only the information contained in open files but also the information contained in files pertaining to prior transactions.

All told, information was reviewed regarding 59 standby letters of credit issued by USNB and still outstanding at the time it closed. In a number of cases, it was necessary to request further information from the holders of letters of credit regarding apparent inconsistencies between documentation in FDIC's possession and information provided by the claimants.

It is impossible to generalize about these letter of credit claims, as virtually each transaction was different. However, the basic purpose of the review was, as indicated, to attempt to determine whether the transactions were two party deposit or loan transactions involving only USNB and the beneficiaries (and thus the type of obligations assumable by Crocker under the Agreement) or whether they were guarantee or typical standby letter of credit transactions involving three parties, one of whom was a member of the Designated Group. As a result of this review, it appeared that in 37 of the 59 letter of credit transactions aggregating $47.7 million in principal amount, the holders of the letters

of credit had no privity of contract, and no contact, or at most minimal contact, with the account parties; further, the account parties' records reflected loans from USNB rather than USNB-guaranteed loans from the beneficiaries. Correspondence with the brokers involved in some of these transactions verified that the beneficiary had been asked to, and in fact intended to, make a deposit with or loan money directly to USNB. USNB, on the other hand, had indicated in its records and on its books that a loan had been made not by the beneficiary to USNB but by the beneficiary to the account party, and that USNB had issued its letter of credit to guarantee the loan. In other words, while USNB's records reflected a three-party transaction, the records of the beneficiaries and brokers reflected a two-party transaction between the beneficiaries and USNB. At the same time, the records of the account parties reflected another two-party transaction between the account party and USNB. Apparently what USNB had done in these 37 transactions was to borrow money from the beneficiary and issue a so-called "clean" letter of credit to evidence the loan. USNB then used the loan proceeds to make a loan to the account party named in the letter of credit. Having issued a "letter of credit" to evidence its primary obligation, USNB booked the letter of credit as a contingent liability or guarantee rather than as a primary obligation and did not book the offsetting loan to the

account party at all, thus avoiding statutory lending and borrowing limits, reserve requirements and a direct balance sheet liability.*/ At the time USNB closed, of course, FDIC had available to it only that information contained on USNB's books and in the Comptroller's Reports of Examination. Only after reviewing all of the records and files available did we learn the true nature of these transactions. In view of these findings, FDIC's Board of Directors determined that, had the true facts of these 37 transactions been known at the time USNB closed, USNB's liability to the beneficiaries on the letters of credit would have been assumed by Crocker under the terms of the Agreement. In June 1974, FDIC arranged for this assumption to take place under reimbursement by FDIC.

As a result of this review, FDIC also determined that 22 of the letters of credit in question (aggregating approximately $42.4 million in principal amount) were, in its opinion, properly booked by USNB as three-party guarantee transactions. That is, the letters of credit themselves, viewed together with the correspondence and other evidence surrounding the transactions, indicated that the beneficiary of the letter of credit intended to and did make a loan to a Designated Group member, with

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*/ Rulings adopted by the Comptroller of the Currency August 9, 1974 in respect of standby letters of credit would tend to frustrate a similar result today.

the letter of credit it received being USNB's guarantee of that loan. The holders of the letters of credit not transferred to Crocker for payment were advised of this decision and that, to the extent allowable by law, they had claims against the receivership. They were further advised that FDIC was willing to cooperate with them in their attempt to collect from the account party, the party primarily liable on the obligation. The actions taken by FDIC are reviewed in greater detail in two press releases issued on June 19 and July 2, 1974, copies of which have been submitted to the Subcommittee for its convenience.

Subsequent to these determinations, the FDIC staff has been working with a number of the beneficiaries of these letters of credit to assist them in collecting the amounts due them from the various account parties. In each case the account party also owes substantial sums of money to the FDIC as Receiver of USNB. Agreements are being negotiated between FDIC and some of the beneficiaries regarding such matters as the priority of future claims against these account parties and the maximization of the recovery of the Receiver and the beneficiaries.

A number of the holders of letters of credit which were not transferred to Crocker have advised FDIC that they disagree with FDIC's findings and have filed with us additional information regarding their transactions with USNB. The FDIC staff and one or more members of the FDIC Board of Directors have met with these claimants regarding

their requests for reconsideration. Each of these claimants will be advised in due course of the disposition of its particular request for reconsideration and of the status of its particular claim.

In addition, a number of persons holding letters of credit which Crocker paid have claimed that they are owed additional sums for interest from the date of the maturity of the letter of credit until the date of actual payment. With regard to these claims, FDIC has taken the position that payment of such post-maturity interest would be improper at this time and under the circumstances present in these cases.

Concurrently with the review of the letter of credit claims filed by the various holders, two court actions have been filed alleging, in substance, that FDIC in both its capacity as Receiver of USNB and in its corporate capacity acted improperly with respect to their claims. The first of these suits, a class action, was filed on November 21, 1973, on behalf of International Westminster Bank and others whose claims were not assumed by Crocker (this suit was referred to in my testimony before this Subcommittee last November). This suit sought to have the Agreement declared illegal on the theory that it violated the provisions of 12 U.S.C. § 194 which calls for the payment of ratable dividends to all creditors of an insolvent national bank whose claims have been proved to the satisfaction of the Receiver or adjudicated in a court of

competent jurisdiction. Subsequent to my prior testimony, the District Court for the Southern District of California dismissed the suit holding that it was filed prematurely and that it failed to state a cause of action upon which relief could be granted. An appeal from that dismissal is presently pending before the United States Court of Appeals for the Ninth Circuit. As of this date, no decision has been handed down by that Court.

A second suit was filed in the District Court for the District of Columbia by Banque Francais du Commerce Exterieur and four other letter of credit holders. It sought a declaration that both the FDIC and the Comptroller of the Currency acted illegally with respect to the USNB transaction. This suit is substantively similar to the International Westminster complaint although it seeks a somewhat different form of relief. The District Court ruled that venue in the District of Columbia was improper and ordered the case transferred to the United States District Court for the Southern District of California. That decision was affirmed by the United States Court of Appeals for the District of Columbia and the case has now been transferred to California. The course it will take will probably depend upon the ultimate decision of the Court of Appeals for the Ninth Circuit in the case presently before it.

An early resolution of these law suits is unlikely, and further litigation may be expected from holders of letters of credit.

III. An Overview of FDIC's Collection Efforts

About 30 FDIC employees are currently engaged full time in San Diego in the collection activities of the USNB receivership. They are aided by several West Coast law firms retained as special counsel for various aspects of this receivership, and the total operation is supervised and coordinated by members of the FDIC liquidation staff in Washington and by the FDIC Board of Directors. Over the next ten years, which we anticipate to be the minimum life of this complex receivership, we expect our personnel requirements and direct liquidation costs to decline gradually. To date, our direct salary, operating and legal expense has approximated $2 million.

The receivership contains approximately 4,400 assets not counting unbooked causes of action, but 3,600 of these are relatively small claims, aggregating only $24.9 million in book value. As I have previously indicated, the bulk of the receivership assets (approximately $345 million) represents indebtedness in one form or another of Smith-related borrowers. Our Liquidation Office believes that this indebtedness may be broken down as follows, although particular borrowing groups may allege, for reasons to which I will refer shortly, that some other group is responsible for at least part of the indebtedness attributed to them.

BCIC and related companies	$126.7 million
Hollis Roberts and related companies	79.2 million
Westgate-California Corporation and related companies	44.2 million
San Luis Rey Development Project */	47.3 million
M. J. Coen and related companies other than BCIC	19.9 million
J. A. Smith and related companies	7.9 million
Miscellaneous loans related to the above	20.5 million
Total	$345.7 million

In each of the six major lines first listed, there appears to have been a close relationship between C. Arnholt Smith and one or more of the principals involved, although at the present time we do not know the full extent of that relationship. There also appears to have been significant and recurring relationships between the different groups, in addition to

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*/ The San Luis Rey line does not represent loans to a group called San Luis Rey, but rather loans secured by property in a portion of California called San Luis Rey. This is approximately 60 miles north of San Diego and includes approximately 2,457 acres under various deeds of trust now held by the receivership. These deeds of trust relate to land owned by 22 different companies. The property appears to be part of a speculative venture on the part of those who borrowed money from USNB to invest in this area. Many borrowers included in other groups are also borrowers in this line.

their separate relationships with USNB. Suffice it to say, however, that this receivership is unusual from the standpoint of the concentration of very large loan lines in the hands of only a few individuals, or in the hands of companies they once controlled, all of whom seem to have had a close working relationship with C. Arnholt Smith.

While the number of controlling individuals originally involved in these six lines may be small, the number of corporate entities encompassed within each line is substantial. Organizationally, BCIC, for example, can be grouped into five major headings totalling 26 companies: boat companies, operating companies, real estate holding companies, shell companies, and miscellaneous other companies. Each of the boat companies, of which there are eight, owns or has owned in the past a tuna fishing boat. Two of the operating companies own shopping centers and one operates an airline terminal and service facility. The five real estate holding companies either own real estate in the San Luis Rey area or in the Kern County area, and one of them owns nothing but shares of Westgate-California common stock. There appear to be four companies which were simply shell companies and were used for manipulation of assets by the control group, only one of which has any assets at the present time. The miscellaneous other companies remaining in the BCIC group own furniture and fixtures, four small airplanes, real

estate in Chino, California, and Ontario, stock in Westgate-California Corporation and a commercial property in Beverly Hills. Even where these corporations own assets, their net worth is frequently so small and their operations so minimal that there is little likelihood that sufficient funds can be generated to repay their obligations in full. The same pattern is present in the other five major lines.

The collection efforts of the USNB receivership are compounded by the necessity of following numerous specific transfers of assets, liabilities, ownership rights, debt, and security interests among and between this large number of companies. Loans which on the books of USNB at closing might appear to be the responsibility of Company X turn out to be, in reality, the responsibility of Company Y or Individual A after the receivership has traced the passage of loan proceeds from company to company or individual to individual. While we feel that we have unraveled some of this complexity and have begun litigation to assert claims we have uncovered, we are not yet sure that we know all the facts about the multiple manipulations that have occurred. Some persons who could shed light on this area, such as C. Arnholt Smith himself, have refused to answer our questions, pleading their constitutional right against self-incrimination. These are matters that will be sorted out, if at all, only over time as our tracings are completed, new information is discovered, or litigation progresses.

It would be too time-consuming at this point to go into great detail on the collection strategy that the Receiver is adopting with respect to each of these six major lines. Likewise, to reveal that strategy or to reveal our estimates of specific anticipated recoveries might in some cases compromise negotiations currently under way with some of the debtors. To give the Subcommittee some idea of the nature of the problems being encountered, however, we have included in the next section of this report a rather full description of our collection efforts with respect to one of the six major lines, i.e., Westgate-California Corporation and its related companies.

IV. A Specific Example: Westgate-California Corporation

Westgate-California Corporation is a large conglomerate whose affiliates and subsidiaries can be grouped into eight groups: seafood, surface transportation, air transportation, real estate, hotel/resort, produce, leasing, and insurance. At the time of USNB's failure, these eight groups included eleven separate companies. Five of the companies are involved in the tuna business, owning three canneries, four tuna boats, and a leased terminal with docking facilities and warehouse. Two of the companies own control of taxi cab companies and operate commuter airline routes. They also lease and own three commercial jets. Several companies own real estate.

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Westgate-California Corporation and its subsidiaries (collectively referred to herein as "Westgate-California") now has debt of approximately $44 million on the books of the receivership, a reduction of $24.4 million since USNB failed. */

Shortly after USNB failed, Westgate-California, represented by a president and board of directors appointed by the Court a few months earlier following compromise and settlement of litigation brought by the SEC, requested from the FDIC a $500,000 cash advance to meet payrolls due in Westgate-California and to pay premiums on directors' liability insurance policies. Westgate-California told the Receiver that advances were needed because USNB had been Westgate-California's bank, that it was not able to acquire quickly other bank lines, and that if the advances were not forthcoming the members of Westgate-California's board of directors would resign and the company would be placed in voluntary bankruptcy. Westgate-California also requested an additional $6 million on a short-term basis for working capital to permit its seafood companies to purchase tuna during the first two or three months of calendar 1974.

In order to permit the receivership time to analyze the operations of Westgate-California, and to permit other banks and insurance companies

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*/ This reduction resulted from the application of $7.2 million in cash payments, $200,000 in offsets made with USNB deposits, and the transfer of approximately $17 million to purchasers of assets who assumed Westgate-California's related debt to USNB or substituted their own obligations for such debt.

which had been financing the operations of that conglomerate on both a short and long-term basis time to make their review of the situation, the Corporation advanced $500,000 on November 29, 1973. That $500,000 advance was subsequently repaid on May 6, 1974.

A few weeks later, the FDIC Board of Directors rejected Westgate-California's request for an additional $6 million advance following extensive analysis and meetings, both in Washington and in San Diego, on the grounds that it could not satisfy itself that any advance beyond the $500,000 previously transferred would serve to protect the total assets in the receivership estate attributable to Westgate-California. This judgment was supported by the decision of the banks and insurance companies which had been long-term creditors of Westgate-California not to make further loans to the conglomerate, and by the fact that commercial banks which had been financing Westgate-California's seafood operations had either withdrawn the lines outstanding or had limited the size of the lines then on their books.

Notwithstanding the Receiver's denial of the $6,000,000 request, Westgate-California did not go into bankruptcy at that time. Rather, in an attempt to raise the needed working capital, Westgate-California made a corporate decision to sell the 1,823,566 shares of common stock of Golconda Corporation which it held and formally applied to the Court which was overseeing its affairs for the requisite permission.

Since the Receiver held substantial amounts of the Golconda stock as security for a loan of $4,500,000 to Wescal Properties, Inc. (a wholly owned subsidiary of Westgate-California Corporation), and since the Receiver claimed an interest in any additional proceeds that might be realized from the sale of the stock on a constructive trust theory, negotiations between Westgate-California and the Receiver were undertaken to see whether some amicable agreement for the distribution of the proceeds of the sale of the Golconda stock could be reached.

Westgate-California claimed, among other things, that there was substantial question whether Wescal Properties, Inc. had ever received the benefits of the $4,500,000 debt shown on the books of the Receiver, and, therefore, whether it in fact owed $4,500,000 to the USNB receivership. It further argued that any additional claim in the proceeds beyond $4,500,000 was totally without foundation. It claimed in fact that there was substantial doubt that Westgate-California had obtained the benefits of a large portion of the other loans due from its subsidiaries on the books of the receivership, and suggested that it was prepared to litigate extensively, in bankruptcy if necessary, to prove the point. Finally, it claimed that the entire proceeds of the sale of the Golconda stock were needed to provide working capital for Westgate-California, and that without it, Westgate-California would collapse and

the collection of the entire debt owed by Westgate-California to the receivership would be jeopardized. The situation was complicated by a lien which the Internal Revenue Service had obtained on all assets of Westgate-California, including the Golconda stock, for the purpose of insuring payment by Westgate-California of a tax claim for $4,200,000 allegedly owed the United States by Westgate-California.

Following extensive negotiations, Westgate-California made a formal request to the Receiver on February 13, 1974 that the Receiver: (1) defer all principal payments on the debt owed by Westgate-California to some unspecified date, (2) cancel any interest now due or to accrue on that debt, (3) waive the Receiver's security interest in the stock of Golconda Corporation, and (4) waive the Receiver's rights to any proceeds of the contemplated sale of Golconda stock. As consideration, Westgate-California offered to confirm and not contest all debt owed by Westgate-California to the Receiver (in amounts to which the two parties might agree based on information then known) and all collateral purportedly held by the Receiver as security therefor. As a further inducement, Westgate-California also submitted financial projections which it claimed showed that, upon agreement by the Receiver to its offer, Westgate-California would be able to pay the principal amount of the debt to the Receiver at some unspecified time in the future.

In due course, the Receiver rejected that proposal since, upon analysis, it was clear that acceptance of the proposal would not have led to a greater recovery for the receivership estate and, in fact, might have led to a lesser recovery for the estate. Negotiations continued with Westgate-California, but no agreement was reached until the parent Westgate-California Corporation and its subsidiary Wescal Properties, Inc. voluntarily went into a Chapter X proceeding on February 26, 1974.

The Receiver was unable to reach an accommodation with Westgate-California prior to its bankruptcy petition, since in all cases the offers made by Westgate-California contemplated the serious weakening of the Receiver's position vis-a-vis other creditors, actual or prospective, and offered as consideration only the prospects of long-term partial repayment that was speculative at best. Westgate-California seemed to feel that the receivership had a continuing interest, as a successor bank, to fund its operations, and that Westgate California's repayment of debt already in default was secondary to protecting the equity interests of Westgate-California's capital noteholders and shareholders. Its arguments were supported only by unaudited figures, and these seemed to change significantly with each request. Upon analysis, none of the figures showed that the receivership would benefit from the requests being made.

The prevailing attitude of Westgate-California had been, until the appointment of a Trustee in Bankruptcy, that the conglomerate should be run as if it was an untroubled and bankable business, and that no part of the conglomerate should be liquidated (with the possible exception of certain real estate it owned in downtown San Diego). The Receiver's analysis was that none of this was possible unless the Receiver surrendered substantial rights and interests it held, a surrender which showed no promise of ultimate repayment. In direct contrast to this approach, the new Trustee, Mr. Curvin Trone, suggested to the Board of Directors of the FDIC in a meeting held in Washington, D.C., on March 15, 1974, that there should be an orderly liquidation of some parts of the Westgate-California operation. He also suggested that the FDIC, as well as other creditors, had some repayment due them and consideration should be given to them as well as to employees, stockholders, and debenture holders of Westgate-California.

The Trustee had filed a petition under Chapter X claiming that it could reorganize Westgate-California successfully. Even though the Receiver formally objected to that petition, claiming that any reorganization would be unsuccessful, the Receiver felt that with the changed attitude reflected by the new Trustee it could properly begin negotiations to see if there was some way to reach an accommodation

which would permit the proceeds from the sale of the Golconda stock to be distributed to the benefit of the Internal Revenue Service, the Receiver, and the Trustee, and permit him a period of time to apply his skills and business experience to Westgate-California's pervasive problems.

The Receiver considered it essential to insure that its position vis-a-vis the Trustee, other creditors of Westgate-California, and equity holders of Westgate-California would not be diminished by any agreement reached with the Trustee, and that the Westgate-California assets did not diminish in value. Likewise, IRS found itself hard pressed to accept anything but full cash payment for the $4,200,000 allegedly owed it by Westgate-California. Westgate-California, on the other hand, needed a significant part of the proceeds of the sale of Golconda stock for working capital or it was meaningless for it to enter into any agreement. Since the proceeds of the sale of the Golconda stock amounted to only $9,752,985.50, it was clear that all parties could not be satisfied completely. In due course, a compromise agreement for the distribution of the proceeds of this sale was entered into on April 9, 1974.

The agreement is lengthy and detailed, but from the standpoint of the Receiver it seemed desirable since (1) the Receiver immediately received $3,500,000 from the sale of the Golconda stock without litigation, (2) the Trustee agreed systematically to use his best efforts to

liquidate in an orderly fashion companies in Westgate-California other than those in the seafood division, within the following two years, (3) payment was committed to the Receiver of amounts obtained from the sale of certain subsidiary companies even though no loan outstanding to such companies then appeared on the Receiver's books, (4) the Trustee agreed to a schedule of debt repayment which would allow repayments made to be applied at the discretion of the Receiver (which meant such repayments could be applied first to unsecured or poorly secured loans thereby keeping the Receiver's good security intact), and (5) the Trustee gave the Receiver security for loans or bankers acceptances that were unsecured at the time. Most importantly, the agreement reflected that one of the purposes of the Trustee in reorganization was to pay creditors of Westgate-California.

From the standpoint of Westgate-California, and indirectly from the standpoint of the receivership, the agreement provided a means whereby Westgate-California could continue normal operations while attempting to sell certain assets and companies. Schedules which Westgate-California furnished at that time showed projections of income and cash flow which indicated that it could and would pay the receivership approximately $4.5 million by the end of 1974, some of it from the proceeds of liquidation and some from current earnings.

Since April 9, there has been some deterioration in the cash flow and income results of Westgate-California's operations vis-a-vis the forecasted results, but there has also been substantial reduction of debt. While it appears at this time that Westgate-California will not be able to pay directly any part of the $4,500,000 projected for 1974, and that the Trustee has failed to meet some of the target dates established for selling certain of the assets in the conglomerate, the Receiver nevertheless believes that there have been substantial benefits accruing to the receivership from the April agreement. Westgate-California has been able to operate in a normal manner and has not been forced to liquidate assets at distressed prices. These conditions made it possible to reach a favorable sale of the downtown San Diego block containing the Westgate Plaza Hotel in the summer of 1974. Similarly, an additional $2,070,280 was paid to the Receiver from the proceeds of the Golconda sale when the IRS released some of its claims earlier this summer, bringing to $5.5 million the total amount realized by the Receiver in this transaction without litigation. We further believe that the April compromise has probably increased our likely net recovery in the whole Westgate-California line.

At the present time, the Receiver is considering a request by Westgate-California's Trustee to restructure the debt from Westgate-California to the Receiver on a long-term basis and to provide an

additional $5 million of working capital on a short-term basis. We are in the midst of analyzing that request at the present time and have not yet reached any conclusions with respect to it.

V. Litigation By and Against the Receivership Estate

Every receivership involves the FDIC in litigation, and there is obviously more of it when the receivership is as large and as complex as the USNB receivership. The principal litigation efforts in which we are currently engaged include the following:

Attacks on the Purchase and Assumption Agreement with Crocker. In addition to the two lawsuits filed by holders of USNB standby letters of credit to which I have previously referred in Part II of this statement, a more recent case has been filed which also attacks certain provisions of the Agreement between FDIC as Receiver and Crocker. This case, 340 Spring St. Co. v. FDIC, represents a cross-claim against FDIC by the owner of a building which USNB leased as a branch office. The building was occupied temporarily by Crocker, but the lease has since been terminated by the Receiver. The plaintiffs seek damages for alleged default on the lease and a declaration that the purchase and assumption transaction with Crocker was illegal to the extent it did not require full performance of USNB's lease obligations. This action was commenced just recently, and no answer has yet been filed by FDIC.

Bond Claims and Director's Liability Matters. FDIC personnel have been conducting a thorough examination of USNB's records since October 1973 with a view to developing and presenting substantial claims under USNB's bankers blanket bond. To date claims totalling $153 million have been filed with the bonding company which wrote USNB's policy, although recovery would be limited to no more than $10 million for each USNB officer shown to have committed independent violations it its terms which may as a practical matter limit total recovery to $10 million.

The FDIC is also attempting to prosecute claims against former directors of USNB. These efforts have been complicated by reason of two actions filed against such directors by minority shareholders of USNB shortly after the bank closed. These complaints, Harmsen v. Smith, et al. and Hansen v. Smith, et al. (which have since been consolidated) sought recovery against certain directors of USNB for alleged violations of the Securities Exchange Act of 1934, for violations of the National Bank Act, and for breaches of their fiduciary duties. The FDIC believes that these actions are essentially derivative in nature and therefore has sought and received permission to intervene as USNB's Receiver. However, the FDIC has been denied the exclusive right to prosecute this claim and is in the process of making an interlocutory appeal of that ruling to the United States Court of Appeals for the Ninth

Circuit. As plaintiff in intervention, the FDIC has filed its own complaint against the directors which seeks recovery, among other things, for alleged violations of the National Bank Act and of the directors' common law duties of care and loyalty.

Franklin National Bank v. USNB. Shortly after USNB was declared insolvent, Franklin National Bank filed a suit requesting rescission and damages in connection with $5 million in capital debentures it had purchased from USNB. The suit alleges violations of the federal securities laws and common law fraud. As of October 8, 1974, the date of Franklin National Bank's own failure, the action was involved in ponderous discovery efforts and had not yet proceeded to trial. However, in the wake of Franklin National Bank's closing and the appointment of FDIC as its Receiver as well, the case has been stayed. The FDIC is currently developing plans to deal effectively and fairly with its statutorily imposed responsibility for handling receivership estates with clearly divergent interests.

Westgate-California Proceedings. In addition to taking the protective legal steps in Westgate-California's Chapter X reorganization proceedings which led to the compromise agreement of April 9, 1974, the FDIC as Receiver instituted a suit in the United States District Court for the Southern District of California against four companies of

the Westgate-California conglomerate. This suit, against Westgate Life Insurance Co., South Plaza, Inc., Westgate Caribe, Inc., and Westgate-California Foods, seeks recovery of $3.99 million. The complaint is based on the apparent practice of shifting the loan obligations of major Westgate subsidiaries to other entities with the result that the loans are still outstanding. The Receiver is currently preparing an amended complaint in this matter.

Additionally, the Receiver has filed substantial claims in Westgate-California's Chapter X reorganization proceedings. These claims seek recovery of $48 million based on continuing guarantees by the parent corporation of subsidiary debts and further seeks recovery of $110 million on the theory that the parent is indebted to USNB by reason of:

(a) Moneys obtained from USNB on loans made under false pretenses and by misrepresentation as to the identities of the borrowers or users of such moneys, the uses of such moneys and the sources of repayment of such moneys, all of which moneys were in fact received and used by and for the benefit of the parent; and

(b) The parent's assisting, agreeing, aiding and abetting C. Arnholt Smith, a director, officer and controlling

shareholder of USNB, in violating his fiduciary duties and duties of care to USNB by obtaining moneys in said amount from USNB for the use and benefit of Westgate-California, without approval of the board of directors or stockholders of USNB, in violation of 12 U.S.C. § 84, without regard to sound banking and credit practices and for the purpose of benefiting Westgate-California at the expense of USNB.

To date, Westgate-California Corporation's Trustee has not acted on these claims or any of the other claims filed against it by others which together aggregate approximately $1.5 billion.

Other Litigation. There are, of course, many more cases both by and against the FDIC as Receiver of USNB. However, most of these cases were pending prior to the bank's closing and are routine insofar as they present legal questions not unlike those associated with normal banking operations. These cases involve such questions as violations of margin requirements by USNB, breaches of contract, general tort claims, etc. While there are approximately two hundred cases of all types pending in the USNB receivership, the matters discussed above relate to legal issues of special significance in the conduct of the receivership.

Mr. ST GERMAIN. Thank you, Chairman Wille.

I might state that we have placed that letter of July 18 in the record of our hearings.

On page 5 of your testimony, you bring up a point that has been brought up by many of our witnesses, to wit, EFTS facilities by certain financially regulated institutions under the moratorium were uninsured and unregulated firms in the private sector and are not similarly constrained.

For instance, you mention nonbank credit card firms and major retailers. You do state that these are unregulated firms that do not operate by charter granted by Federal or State government as is the case with financial institutions.

Chairman WILLE. Most all of these corporations would be incorporated under State law in one of the 50 States and doing business elsewhere.

Mr. ST GERMAIN. But they are corporations that are not regulated by any particular agency?

Chairman WILLE. They are not regulated as financial institutions.

Mr. ST GERMAIN. They do not receive public funds deposits. They do not tax account moneys with no interest to be paid on them. They do not have escrow accounts. Thus, I wonder if it is quite accurate to compare the two.

I think the issue is do we begin to react to what is done by these unregulated firms, and state that well if it is good for them is it good for our financial institutions? Or, do we have to look at financial institutions from a different perspective because by their very essence they are similar to a public utility. They have got a quasi-monopoly in the area.

Do you think it is really fair to compare the two?

Chairman WILLE. I would agree that financial institutions must be regulated in a different manner than these nonbank firms, but the point of the reference was to point out to the subcommittee that these firms can go ahead and develop what basically electronic fund transfer systems and they can do it in a way which will competitively impact the banking and S. & L. communities, while the latter are subject to a moratorium.

Mr. ST GERMAIN. Many of them have been doing this now for a number of years prior to any financial institutions going in. American Express; Sears, Roebuck; BankAmericard——

Chairman WILLE. Well, the activities of these firms are being stepped up at the present time in the light of technological developments. The capabilities of these machines are obviously far greater than they were 3 or 4 years ago and they are being put in place more extensively in the branch stores of these particular retailers that you mentioned. And, indeed, the nonbank credit card firms also have the capability of significant electronic funds transfer.

There seems to be some inequity in allowing them to proceed while banks and S. & L.'s are restrained, although I would concede your point that they are different institutions and should be treated differently for purposes of regulation.

Mr. ST GERMAIN. Chairman Wille, in your statement you recommend the deletion of all references to commercial real estate loans and state the assumption that construction lending or other loans on commer-

cial real estate should be confined to the localities where a financial institution's head office or a branch is located is not valid.

There is no provision in the bill that requires either residential or commercial mortgages to be confined to a certain locality. Second, it is not only the availability of mortgage funds that determines whether or not an area is disinvested and can be brought back and reinvigorated and reenlivened. The availability of money is only one factor.

But, as has been quoted by so many administration witnesses who bring up the plan that started in Pittsburgh, the NHS plan, and in those other plans, they put up funds for special loans to individuals in the community for small businesses because it is necessary to have jobs in the area such as the garment district in the situation just cited by Secretary Gardner. Do you not think that the commercial loans not only from real estate but for business purposes are also important to a disinvested area to determine whether or not that area is receiving not a proportionate share, not an exact share, but some share of the funds that come from that particular area?

Chairman WILLE. I certainly do not want to leave the impression that I believe commercial redevelopment in these urban areas is not desirable, nor that some record of the types of investments that are being made in the commercial sector is undesirable.

I think both your comment and mine go to the question of the complexity of being fair about this matter. Suppose, for example, in a given area in which an institution is receiving funds from thousands of depositors that might equal $1 million, the firm had no residential mortgage loans in that area but it had made one major commercial loan for a particular development project of, say $2 million.

Let us assume that that is reported in the aggregate, along with other financial institutions which have, to the contrary, made $2 million worth of mortgage loans in the same area. The two firms are conducting very different banking operations in that particular area and are not strictly speaking comparable, on the basis of the statistics that might be collected from this effort.

It goes to the question of whether or not a simple type of reporting of deposits and loans in a given area tells either a legislative body or an administrative agency much that is important.

What you will find, I suppose depending upon how you define what is to be reported, is a complete lack of investment in certain areas. And you might want to inquire further as to why that is the case. And, in fact, if there is discrimination in lending based on race or color, that may be one of the responsibilities which the agencies have in their examination processes under the Equal Credit Opportunity Act to go further than the mere statistics that no money is being placed in a given area.

But that relationship is not exact and it is not a direct correlation. And as I say, I think both your comment and mine go to the complexity of this effort to be fair.

Mr. ST GERMAIN. I will pursue this a little further in my next part of the questioning. My time has expired.

Mr. Patterson?

Mr. PATTERSON. Good morning, Mr. Wille.

You indicated, I think, on pages 7 and 8 of your testimony, your position with regard to the moratorium which I am not sure I com-

pletely understand. You are urging guidance from Congress as an alternative to moratorium, in terms of a definition of what is a branch.

In your opinion, what would be your response as to what should be determined a branch, should the EFTS units be considered such?

Chairman WILLE. I do not believe the EFTS units should be considered a branch in the normal bricks and mortar sense of that word. It is a different kind of facility than the Congress ever contemplated when it passed the statute back in 1933. It is just much too recent a development for Congress to have had that in mind, either then or in the McFadden Act.

On the other hand, we are dealing with an existing statute. Each one of the agencies has had to look at this question and try to figure out in its own mind if Congress were to address this question today, would they include EFTS facilities as a branch for purposes of regulatory approvals?

The Comptroller of the Currency has come to the conclusion that, no, it would not, and that therefore he will take the view that these are not branches.

If, in fact, the courts later find that they are, you have a built-in reference to State law in the McFadden Act and there is a question as to whether or not that State law should control for purposes of these electronic funds transfer facilities.

It seems to me that by avoiding the basic issue here, which is the branch question, the Congress certainly is buying time for the National Commission to respond in a considered way as to how the Congress should move.

On the other hand, sooner or later the question is going to have to be faced because the Supreme Court of the United States will decide it one way or the other. And, in some recent cases they have indicated a fairly strict view of what is a branch under Federal Banking law, even though the Congress might not have had a particular type of facility in mind back in 1928 or 1933.

For example, in the *Plant City* case in 1969, I believe it was, they found that armoured car service in the State of Florida was branch banking within the meaning of the Federal banking laws. And they conceivably, on the basis of that precedent, might find these electronic funds transfer facilities also branches, depending upon the functions which they perform.

And, sooner or later, as I say, I think the Congress is going to have to respond to whatever the courts decide in this area, as a preliminary matter: and, where seeking for that guidance now, you could short circuit 2 or 3 years of litigation were you to take that bull by the horns and tell us whether or not you believe they should be treated as branches for purposes of regulatory approval and references to State law.

Mr. PATTERSON. And would this apply, then, to both Federal and State, if the Congress would make such a determination that there were or were not branches?

Chairman WILLE. Well, I have to separate the answer to that question. Depending on whether or not you are talking about a Federal commercial bank, that is, a national bank, or a Federal S. & L.

Unfortunately, the answer is quite clear with regard to commercial banks. If you decide that way, yes, then they must be approved by the regulatory authorities in accordance with existing State laws, State by State, since they are incorporated by reference in the McFadden Act.

The S. & L. situation is quite different. There is no present branching law affecting Federal S. & L.'s in the Federal statute books, and therefore, were you to decide that these were branches, you would have to approach that problem rather specifically for S. & L.'s and write the statute relating to these electronic funds facilities separately from the present arrangement.

Mr. PATTERSON. If we took your other suggestion that the moratorium not apply except to interstate EFT facilities, would we, in effect, be really declaring any moratorium? That is to say, is there really anything going on interstate? Is not most of the action in the intrastate?

Chairman WILLE. Most of the action currently is in the intrastate area. However, it would be a mistake to believe that financial institutions are not making plans for interstate facilities in some way connected with the main office, or a branch office of a national bank.

One reason that we have suggested that the moratorium can more reasonably apply interstate than intrastate is precisely because there has not been much development yet in actual placement of facilities across State lines. And that from your point of view, if you are seeking a delay while the National Commission is appointed and while it considers this issue, that might be one logical way to frame the moratorium.

Mr. PATTERSON. Does that give any unfair advantage? For example, you cite that if the reverse were true it gives an unfair advantage to the Federals. Now would this moratorium only on the interstate give any unfair advantage or disadvantage?

Chairman WILLE. I do not believe so, because in fact State-chartered institutions are not branching across State lines. I do not think any of them have authority to do that under their State laws. So you would not be disadvantaging the national bank system by doing that, or the Federal S. & L. system by doing that.

Mr. ST GERMAIN. If the gentleman would yield?

Mr. PATTERSON. I would be happy to.

Mr. ST GERMAIN. A financial institution is operating in State A and its main office is there. But it wants to go into EFTS in State B where it has branches, because of the grandfather clause. We tell them no, you cannot do that. By the same token, those institutions whose parent offices are in State B, can and would be able to proceed with EFTS in State B under this concept that you propound.

Therefore, would there not be a competitive disadvantage with that institution that has branches in another under the grandfather clause?

Chairman WILLE. There are limited examples today where a bank in State A has a branch in State B. The one that comes immediately to my mind is on the west coast. I think it is Bank of California, if I am not mistaken, that has branches in Portland, and I believe perhaps in Seattle also, as well as in addition to all of its branches in California.

It is my understanding that what was grandfathered was their existing branch offices at the time the McFadden Act was enacted and that

they do not have the authority at the present time to place new branches in either the State of Washington or the State of Oregon.

This has been the subject of some litigation recently when a second facility of some kind was attempted to be established by the Bank of California in one of those two States. I am not sure of the outcome of that litigation, but there certainly is a clear restraint on the extent to which that bank can branch in State B in the chairman's example, under the grandfather clause.

Mr. ST GERMAIN. Does not Citibank now have something like $45 million committed to hardware for the metropolitan area that would break them into New Jersey and Connecticut?

Chairman WILLE. I do not know the answer to that question and I would suggest that you address it directly to them.

Mr. ST GERMAIN. Well we can state definitely that that being the case they are going interstate there. Under the 50-mile radius ruling of the Comptroller, you can go into another State.

Chairman WILLE. That is not the same as our suggestion. I understand the Comptroller's ruling, but the corporation's suggestion is that if the committee wants some sort of a moratorium while the National Commission is reviewing and reporting on the question, it could step in and say that that type of interstate expansion will be held up until such time as the National Commission reports. We think that that is a feasible way of proceeding should the subcommittee desire to go that way, without affecting Citibank's right to expand in New York State.

Mr. PATTERSON. My time has expired, Mr. Chairman. Thank you.

Mr. ST GERMAIN. Mr. Rousselot?

Mr. ROUSSELOT. Thank you, Mr. Chairman.

Mr. Wille, we appreciate having you here again and to have your views on the various subjects in the bills before us. On the basis of your discussion in your testimony on the potential moratorium, what are your views concerning the effect of an EFTS moratorium on the ability of financial institutions to compete with nondepository enterprises which are already operating electronic credit authorization facilities?

Chairman WILLE. Well, I believe that if there is a total moratorium, that ability to compete would be seriously curtailed depending upon the length of the moratorium. I think the fear about the 90-day moratorium, which is across the board, is that it would be periodically extended to longer and longer time periods.

In my statement there is a reference to the fact that the lack of regulation with respect to these nonbank credit card facilities and retail companies in particular is one reason why we would oppose a total, across-the-board moratorium of all EFT developments by financial institutions, particularly the intrastate development.

And, therefore, I think we have addressed the point you are making in our statement.

Mr. ROUSSELOT. I notice you mention in answer to the other questions and in your testimony, that we really, as far as an interstate matter, you really do not see any present necessity for being concerned that EFTS facilities would in fact be a branch, or appear to be a branch?

Chairman WILLE. I was not quite sure of your first phrase in the interstate area?

Mr. ROUSSELOT. Intrastate area. You made it clear that you really do not think that EFTS facility is in fact a branch.

Chairman WILLE. I do not think it is a branch in the sense that Congress contemplated branches back in 1928 and 1933. It is like armored cars. They were not considered either, back then.

Mr. ROUSSELOT. If it became possible for the EFTS to perform more services than are now contemplated or feasible on the basis of the state of the art right now, where would we draw the line? Or where should we draw the line as to whether it is or is not a branch?

Chairman WILLE. Well the present definition of a branch in Federal banking law includes a place where checks are cashed or loans are made. I think that that is not usually the case with one of these terminal facilities.

Mr. ROUSSELOT. No, it is not.

Chairman WILLE. The third reason why something is a branch today is that it receives deposits. Now these machines do a lot of things, some of which include the receipt of deposits and some machines do not. And, indeed, the first court case that has been decided in this area in Colorado said that to the extent that one of these machines does receive deposits, that is a branch function under this definition and, therefore, to that limited extent, the Comptroller's ruling was invalid.

The Comptroller is appealing that and the final outcome, I am sure, will come from the U.S. Supreme Court some day.

Mr. ROUSSELOT. Is it your judgment that if it receives deposits, that it is. in fact, a branch?

Chairman WILLE. I think that is the clearest case in which the Comptroller's ruling can be challenged.

Mr. ROUSSELOT. What is your judgment?

Chairman WILLE. I think it may depend upon the technological connections between that facility and the bank's main office. It depends on whether or not the bank can claim that the technical receipt of those deposits actually occurs at an authorized branch or main office.

In the *Colorado* case it was a very separate receipt of deposits. It was very factual that a man went around and picked up these deposits that were included in a receptacle each day, and I assume that some of that would have to still be done in most cases.

Mr. ROUSSELOT. Well, it is your judgment that it begins when the machinery gets into receipt of——

Chairman WILLE. Well, you see what we are getting into, you can have such fine distinctions between whether or not one facility is a branch and another is not that some congressional clarification in our judgment would be a help here, rather than forcing everybody into litigation.

Mr. ROUSSELOT. Do you really think Congress knows enough about the banking and savings business to make that judgment, that fine line decision?

Chairman WILLE. I do not say that they ought to come out and say these are branches. In fact, the Congress may come out and say these are not branches, but they ought to be handled in a certain specific way by the agencies. That, too, would be of a help to us.

Mr. ROUSSELOT. All right, now, you mentioned the two basic definitions. Supposing if a person has an account at a given institution and

a terminal or EFTS machinery allows him to make a loan on that. Would that then, to a limited degree would that then become a branch, in your judgment? In other words, it can print out a check.

Chairman WILLE. Well, I think the Colorado judge had some pretty good advice to give on that score. He likened some of those extensions of credit to things that are done today, not by means of a new loan decision, but by means of a takedown of a line of credit, and it was his belief that the takedown was not necessarily the making of a loan in the sense that the Congress meant in 1928 and 1933.

Mr. ROUSSELOT. I think that we have to assume that each institution would put some kind of limitation as to what the person could take out of a terminal in the way of a loan.

Chairman WILLE. It would probably have preauthorized that.

Mr. ROUSSELOT. I mean just like the credit card companies usually establish various kinds of ceilings. Now assuming those kinds of ceilings were established, you could go get a check that you could cash and that, in effect, is a loan.

Chairman WILLE. That is a good lawyer's question. I do not propose to answer it right here.

Mr. ROUSSELOT. Well, you are our insurer.

Chairman WILLE. Well, from our point of view I do not think it is going to affect the risks of the Federal Deposit Insurance Corporation, whatever you call it. I mean the money is there; it is being managed by a given institution, and whether or not it is drawn in one way or another, it is not going to affect us.

Mr. ROUSSELOT. And you have looked enough at these machines to believe they can be controlled enough so somebody cannot come rip it off?

Chairman WILLE. You are talking about the security aspect of these machines? I would have to say that the security protection of the EFT facilities is a matter which is of considerable concern, not only to the four banking agencies, including the Federal Home Loan Bank Board, but also to the Department of Justice which is concerned with bank robberies and attacks of one kind or another. It was the Department, you will recall, who was responsible for the Bank Protection Act of 1968 with regard to the bricks and mortars branches. Their concern here is equally appropriate.

Mr. ROUSSELOT. Well, my time has expired, but I would be interested also in beyond what you have already commented on in your testimony what your judgment is of the value to the customer on an EFTS system.

Chairman WILLE. Well, I have no doubt that these facilities provide a considerable measure of convenience for some customers, not necessarily for all of them.

Mr. ROUSSELOT. Certain types, if they are well screened, is that right?

Chairman WILLE. Well, they may have a previously established relationship with the bank. Mrs. Boggs and Mr. Gardner were talking about that relationship. Without a human contact somewhere, you do not have such a relationship and cannot establish one through a machine.

Mr. ROUSSELOT. I thank the gentleman. Thank you, Mr. Chairman.

Mr. ST GERMAIN. Mrs. Boggs.

Mrs. Boggs. Mr. Chairman, unfortunately, I am late for an appointment. I thank Chairman Wille so much for his testimony. I would like to yield the balance of my time to you, Mr. Chairman.

Mr. St Germain. Thank you, Mrs. Boggs. By the same token, remember the experience when all the banks went into credit cards? There was not much personal contact there, was there?

Chairman Wille. Not in the way some banks distributed those credit cards initially.

Mr. St Germain. They just sent them all over the place.

Chairman Wille. They learned a lot of lessons from that, Mr. Chairman.

Mr. St Germain. Page 6, in this regard, these administrative rulings may result in a fundamental and basic change in the essentially local character of retail banking in the United States without benefit of any conscious study, analysis or approval by the legislative branch. Are you not saying that if you put these terminals all over the place, you will be affecting the local banks? These EFT terminals are really in competition with the local banks, particularly since the vice president of Citibank said that a terminal can do 80 percent of the work of a branch.

Chairman Wille. This comment was made particularly in connection with the interstate question, but I would take up the point that you have mentioned, by saying that the impact, the competitive impact of these facilities is something yet to be fully determined. We have heard a lot of fears expressed on the part of the smaller community banks and the independent S. & L.'s. There is some real question as to whether or not a machine without a bricks-and-mortar type of branch can actually make a competitive inroad in the market where that out-of-area institution does not have full-service branch facilities.

Mr. St Germain. That is true, but by the same token, you know other witnesses over the years have said that when a bank is big, people have more confidence in it. They think it is safer.

Chairman Wille. Was that before or after 1972?

Mr. St Germain. That was up until U.S. National and Franklin, but still according to the Gallup Poll Commission, by the ABA, that thought still pervades. Thus, if Citibank puts up a POS terminal a couple of blocks from John Doe's house, he will say, well, gee, that is a pretty big bank. If I have to borrow money and my credit rating is good they will have it; the local bank may be short at the time.

Chairman Wille. Well, you are absolutely correct in pointing out that this is one area in which we have to be very careful.

Mr. St Germain. We have to study that; is that correct?

Chairman Wille. Well, we believe we can monitor the competitive impact of the facilities that are being established and we intend to collect as much information as we can about the EFT facilities that are actually put into place, to actually see what competitive impact these facilities have on a local bank. Now that information will be available to this subcommittee, as well as to the National Commission, as we develop it, but as the Comptroller has said in his testimony last week, not that many EFT facilities have actually been established. He said something like only 30 or 40 applications have been filed with his office.

Mr. St Germain. Thirty-one.

Chairman WILLE. The sample from which you are assessing this competitive impact is not yet very large, nor has the duration or their existence been very long. As we develop that, we will give it to the subcommittee.

Mr. ST GERMAIN. All right. When you talked about whether or not you felt a terminal was a branch and you defined the three points, were you relying on the McFadden Act definition which was written back in 1933 and which knew as much about EFTS today as we, who read Buck Rogers, felt that *Soyuz* would join up with *Apollo?* Is this why you suggest that a new look is warranted.

Chairman WILLE. Yes. I am looking for the Congress to give us that guidance. Your own solution is to let the National Commission give us that guidance.

Mr. ST GERMAIN. OK, is FDIC concerned in the area of EFTS fraud, and do you feel that concern in this area of fraud and/or privacy should be addressed by any of the Federal regulatory agencies?

Chairman WILLE. I do not know that those two questions are completely related, fraud and the branching question.

Mr. ST GERMAIN. No, fraud and privacy. Whether or not an installation is considered a branch or not, there is still the question of the possibility of fraud.

Chairman WILLE. I would answer the fraud part of that question in a manner similar to what I said to Congressman Rousselot, that, in effect, this is a source of concern to us and just as we are concerned with data processing centers and EEP installations, we are concerned about the possible fraudulent use of these new technological developments. You are quite right that this requires a significant monitoring and caution by the banks that install these machines as well as the bank agencies that supervise them.

Mr. ST GERMAIN. Well, here is my concern about the agency. Will the FDIC be responsible for fraudulent losses to deposit accounts antedating from the supermarket experiment, for example?

Chairman WILLE. We will not be so responsible unless the bank actually fails—and I would hope that none of the facilities would end up with that result.

Mr. ST GERMAIN. Would FDIC be responsible for fraudulent losses to deposit accounts when someone manages to tap the EFTS from a phone line or some other external connection?

Chairman WILLE. That is the same answer, Mr. Chairman, that we do not insure specific deposits within a bank or its particular use of funds so long as there is no actual failure of the bank.

Mr. ST GERMAIN. Are you saying, then, that you think the bank is responsible, or the customer?

Chairman WILLE. I think the bank is responsible for the type of installation that it creates.

Mr. ST GERMAIN. Therefore, if there is fraud or a tapping, there is no question in your mind that the responsibility lies with the financial institution and not with the customer?

Chairman WILLE. If it is the customer who fraudulently uses the card, obviously the bank cannot be responsible for that, at least as between itself and the fraudulent customer.

Mr. ST GERMAIN. No; certainly not.

Chairman WILLE. Each of the banks that is installing these is attempting to find the foolproof method of constructing the plastic card. There is this little piece of metal that is incorporated between the bindings or something, and it is supposed to be relatively foolproof. We will see, but since the credit card experience, I think that banks are going to be extremely cautious and are being very careful in this area.

Mr. ST GERMAIN. But the ingenuity of man has to be reckoned with, and that is why I asked you if, in your mind, you feel the financial institution, rather than the customer, would be responsible, absent the fact that the customer, himself, or herself, is committing the fraud.

Chairman WILLE. There is a very interesting group at work in California which is attempting to find ways in which customers or others can beat the system no matter how technologically refined an EDP installation is.

Mr. ST GERMAIN. They have done it with the telephone company on long distance calls.

Chairman WILLE. They have done some extraordinary things and hopefully the banks are learning from that experience and the results of the group's work.

Mr. ST GERMAIN. Would FDIC insurance fees to those institutions utilizing EFTS be increased in the instances of losses by way of EFTS fraud?

Chairman WILLE. Again, Mr. Chairman, not unless a bank actually failed, and the failure of that bank had a financial impact on the assessments paid throughout the system. By law FDIC premiums are based on total domestic deposits of a bank.

Mr. ST GERMAIN. I am just asking if FDIC has contemplated whether you might have to crank in this additional factor for those institutions using EFTS, where there has been substantial fraud against the institution.

Chairman WILLE. I think to the extent that the FDIC itself is not responsible, or does not need to make up those losses, we are not an insurance company for fraud losses; we are an insurance company for deposit losses. That being so, an adjustment would not be necessary.

Mr. ST GERMAIN. Well, that being the case, what controls does FDIC presently have, if any, for monitoring the size and frequency of transactions in the case of a problem bank that is using EFTS equipment or sharing such equipment?

Chairman WILLE. Well, we have the whole range of remedies and powers which currently exist with any problem bank. I do not believe that the EFT problem changes those powers that are needed or the extent to which we might use them.

Mr. ST GERMAIN. But, since there is a possibility—of fraud in these EFTS experiments, has FDIC made any provisions for monitoring the EFTS system in a problem bank. For would that not affect the financial stability of that financial institution?

Chairman WILLE. Our intention is to monitor the establishment, the technology used in all the EFTS facilities, and the way in which that facility integrates with the rest of the bank. It is not going to be something we do solely for problem banks. We are going to do it for

all insured nonmember banks, and to the extent that any EFTS facility would contribute to major problems at a given bank, I am sure that all of the bank agencies would attempt to use their current powers to meet that problem. I do not know at this point that special powers will be needed. I think we have adequate powers.

Mr. ST GERMAIN. It is not a question of powers. I am looking at the fact that the FDIC has a special interest because of the FDIC fund, to which all banks contribute. I would think that you would want to preserve the integrity of that fund as much as possible.

Chairman WILLE. Our special interest would occur, as I stated, if a given institution actually fails because of some fraudulent use of the EFT facility or if a situation is created in which a large number of banks were in danger of failing because of the EFT development. At this juncture I cannot say that that would happen at all.

Mr. ST GERMAIN. Mr. Rousselot.

Mr. ROUSSELOT. Mr. Wille, on page 9 of your statement regarding mortgage disclosure, we appreciate your very complete analysis of each subject. It is very helpful. You say as a minimum data relating to the demand for real estate loans in each neighborhood and data relating to rejected applications for real estate loans by neighborhood would be necessary, and I appreciate that statement because that comes out here and there by various people who have some understanding of how you make loans and where you make loans. So we are glad to have your statement, and have that backup to that position that you have to consider demand as well as "need." Do you have any idea how such information or data could be obtained?

Chairman WILLE. It is not an easy thing to do in a simple questionnaire or reporting system. We are trying to develop a meaningful system of reporting in the residential mortgage area.

Mr. ROUSSELOT. You are?

Chairman WILLE. Yes; we are. That is the four-bank regulatory agencies, in seeking to meet our responsibilities under the Civil Rights Act of 1968.

Mr. ROUSSELOT. When do you guess that system, reporting system, be ready?

Chairman WILLE. Well, we had different ideas about what type of information to collect, and we tried different systems in different metropolitan areas. We have done a pilot study of this in 18 metropolitan areas; 6 of them used an FDIC-Federal Reserve form; 6 used a Federal Home Loan Bank Board form, and 6 used the Comptroller's form. I cannot say yet that we have the solution as to whether or not statistically you can find out whether or not a bank is discriminating against a given area.

Mr. ROUSSELOT. On a geographical basis?

Chairman WILLE. On a geographical basis because there are so many other elements of the credit decision that has to be made, that have to enter into the bank's consideration. We have not given up on that. We are looking at the results for each of these 18 metropolitan areas, 12 of which have been published, 6 of which have not been published.

Mr. ROUSSELOT. When do you anticipate the total effort on the part of the four agencies might be complete in this whole area?

Chairman WILLE. I think we will have made a considered assessment and have obtained some feel for what next might be down in this area within the next 4 to 8 weeks.

Mr. ROUSSELOT. So, certainly, by the fall.

Chairman WILLE. Yes, sir.

Mr. ROUSSELOT. Well, maybe, before we moved on title III of this bill, we should really take a hard—will all four agencies, you think, be complete? You mentioned four.

Chairman WILLE. Yes; three have already published the results, the Comptroller as recently as last Monday. The Federal Home Loan Bank Board is the one agency which has not yet published the results from its survey in six metropolitan areas. What we did in these areas, just for your own information, we adopted the form of the Comptroller and the Federal Home Loan Bank Board in 12 of the areas for our own banks, so that all of the information in any one of these areas was the same, regardless of whether it was an S. & L. or bank or whether they had a State or national charter. The results, so far, have not been very encouraging, at least on the form that the FDIC used, which was a fairly simple type of form, and the simple form does not provide the full answer.

Mr. ROUSSELOT. When you say it is not satisfactory, you mean you just cannot get a handle on it, or it is not complete enough information, what?

Chairman WILLE. I will send you, Mr. Rousselot, the results of our effort, and I think you will see that it does not give a very good handle on the redlining problem. The Comptroller's form was a much more detailed and complicated form. It asked for income data and a number of other things relating to applicants. His results are also published, but there was considerable difficulty in interpreting the response and in getting accurate answers. These are things that are filled in actually by loan applicants and, in some cases, applicants whose loan requests had been rejected. We have to take another hard look at this whole record data collection system on residential mortgages to see if we can come up with something using the best experience of all of these experiments. I cannot say at this point we feel we have or are confident of an answer, but to the extent that this subcommittee moves forward with title III as it is now worded, it is going to get into exactly the same problem that we were in with respect to these 18 metropolitan areas, but on a nationwide scale.

Mr. ROUSSELOT. So, we might, as a subcommittee, really be forestalling problems for ourselves by just waiting until this work is really completed?

Chairman WILLE. Well, I think you should benefit from our experience. Your judgment as to what now can be done, I think can be taken in the light of the agency experience, trying to collect some of this data on an experimental basis, and you may have a better answer than we are going to come up with. I cannot say that yet, but I think it is something that we can work on cooperatively, probably to mutual advantage.

Mr. ROUSSELOT. Well, since you mentioned demand for real estate loans, is that an important factor in consideration?

Chairman WILLE. To the extent that there is little demand for a particular type of loan, the fact that there is really not much money invested in a given area would be considered natural. So that whereas the one assumption might be that a bank collecting a good deal of money in the form of deposits from a given area is not doing its job by returning some of that money to the same area, the explanation may be that there really is not much demand for that money.

Mr. ROUSSELOT. Or credit worthiness to want to make demand?

Chairman WILLE. Well, there may be demand, even without credit worthiness, but that is still a factor that should be considered in any publication of these statistics because it relates again to the question of fairness and interpretation of the data that would be collected in this way.

Mr. ROUSSELOT. My time has expired.

Mr. ST GERMAIN. Chairman Wille, as you know, the Home Loan Bank Board has an elaborate system established for the application for EFT systems, whereas the Comptroller requires a notice of intention, essentially.

Bank X installs an EFTS system. It is found that that system is not as secure as it might be against tappings or fraud. Bank Y's directors have also gone ahead and contracted with the same firm.

Now, as you know, it has happened—I am not saying it will, I hope it will not—but it has happened. We had contentions from the LEAA that one particular firm with radio communications equipment wined and dined people around the country. And as a result thereof, this one particular firm is quite predominant in the area of communications that were purchased under the Law Enforcement Assistance Administration.

So some directors are wined and dined by these people who are peddling this particular system that is amenable to fraud. OK?

Do you feel that proposals should be drawn up for penalties, criminal and civil, against directors who establish such systems?

Should the same penalties apply to officers, directors, and management of an institution that is employing the system that is susceptible to fraud?

Chairman WILLE. Well, I myself would not extend the penalties. We have not suggested applying remedies, by way of administrative fine or removal, to the kind of situation that you are referring to, largely because I think that we have sufficient power today in the different bank agencies to label that particular installation as an unsafe or an unsound banking practice, if it is open to that kind of fraud.

We could use our cease-and-desist power to prevent the bank from using that kind of equipment, if, in fact, the fraudulent possibilities were demonstrated. I think the important thing here would be to prevent or to stop the use of such facilities rather than to attempt to fine or remove an officer because he made a mistake in backing a particular manufacturer for a machine that obviously was subject to that kind of fraud.

Mr. ST GERMAIN. Well, as I stated earlier, $45 million has been committed for hardware by Citibank for their facilities in Connecticut and New Jersey. Let us say that it is found 6 months from now, before

these are all installed, and yet they have spent the money, that they can be tapped.

You would then issue a cease-and-desist order and that should do the trick, cure all the problems?

Chairman WILLE. I think it could cure the problem.

Mr. ST GERMAIN. Well, the bank is going to yell and scream about all the money it has committed.

Chairman WILLE. I suspect, Mr. Chairman, they would yell and scream if you attempted to fine their officers or remove them because they backed the manufacture of this particular kind of a system.

Mr. ST GERMAIN. Well, the point is, they can yell and scream if they ask them to pull back from a system to which they have committed a substantial amount of money.

Chairman WILLE. I suspect they might have to spend a little more money. I suspect their response would be to spend more money to see if they could not make their particular system foolproof or to overcome the possibility of tapping, such as you said.

Mr. ST GERMAIN. The Mitre Corp. recently had a seminar here about security.

Did anyone from FDIC monitor this particular meeting?

Chairman WILLE. I know the meeting to which you refer. I think some of our people were in attendance. I myself was not present. I was invited, but I did not go.

Mr. ST GERMAIN. I was not invited.

Do you see any chance that consumers could in any way be jeopardized by such an event as a haphazard arrangement with a central clearinghouse data bank? Have you analyzed that?

Chairman WILLE. We have not separately examined that question with respect to these EFT facilities. However, we have somewhat the same problem with regard to the centralized data processing centers, which process by computer the workload of a number of banks.

These data processing centers are located throughout the country, and many of them service a large number of insured banks. We do examine these facilities, and we do our best to see that adequate internal controls are maintained. I am sure that we would do the same in the case of such a centralized data bank for these EFT facilities.

Mr. ST GERMAIN. Incidentally, Chairman Wille, on page 10, you refer to the detailed information regarding loans and deposits at home offices and all branch offices. This point has been made by quite a few of the witnesses. I assure you that this certainly will be corrected, because the legislation before us, except for the regulation Q section, is for purposes of discussion and for the purpose of allowing the regulatory agencies to make contributions to us and to assist us.

Chairman Wille, are you familiar with the legislation that has been proposed by the Fed with respect to the waiver of the 30-day notice on bank holding company acquisitions of failing banks and the intrastate acquisition?

Chairman WILLE. Yes, sir; I am.

Mr. ST GERMAIN. Would you care to comment?

As you know, I first introduced both by request in one bill. I then separated the Siamese twins, because I decided they were not Siamese twins, and later introduced a 30-day waiver of notice, separate and distinct from the interstate acquisition.

Chairman WILLE. I think your separation was probably well advised, because the first section of their proposal, which relates to the 30-day provisions under the Bank Holding Company Act is, in our judgment, a worthwhile change in the Federal banking laws, which would enable the Federal Reserve in a number of emergency situations to act far more quickly than can be done today if a bank holding company is the acquiring institution. We support that recommendation in full with respect to that 30-day waiver.

The second section of the bill, which relates to the interstate acquisition of troubled banks—that is, large troubled banks; their figure is $500 million or more—is a proposal which has some very basic issues in it concerning the future of our banking system. I think that these cover many of the areas that will be covered in your own FINE study.

Our view on that particular proposal is that, in some limited situations, an ability to approve an interstate acquisition of a large, troubled bank could be helpful to the bank agencies as they attempt to resolve the problems of that bank. We are recommending, in a hearing tomorrow before the Senate subcommittee, that some amendments be made to the Fed's proposal.

We would suggest that there be explicit provision for the prior approval of the Comptroller of the Currency if the bank to be acquired is a national bank; and similarly the prior approval of the State supervisor if the bank to be acquired is a State chartered institution. Similarly, if the FDIC is being requested to provide financial assistance or guarantees in connection with the long term resolution of a given bank problem, we recommend that the prior approval of the FDIC also be obtained before the Federal Reserve acts.

We have some concern about the dollar cutoff in the bill. The Fed is proposing $500 million. And it seems to me that there are two directions in which the subcommittee might move. The effect of the $500 million cutoff is that banks over that size will be, I think, effectively insured to 100 percent, and that the public will soon recognize this. And the effect of the bill may be to accelerate the development of a two-tiered banking system, in which larger banks are treated differently and more favorably than smaller banks below the particular cutoff selected.

To avoid this two-tiering effect altogether, one solution might be to reduce the dollar figure to zero. In other words, any bank that is in an emergency situation, regardless of location, might be acquired interstate by a bank holding company, with appropriate supervisory approvals.

I think it is fair to say that this would be the solution supported by at least one member of the FDIC Board of Directors.

My own suggestion, which I made in Kansas City, was that the dollar limitation in the Fed's bill of $500 million be raised to $2 billion, which would not avoid the system of two-tiering but would minimize it, in my judgment. It would limit the coverage of the bill to 15 States rather than to the 39 or to all 50 if the dollar cutoff is reduced to zero. A $2 billion cutoff would get at certain types of problems which are not easily resolved by the FDIC. That is, in a nutshell, the kind of testimony we will present tomorrow on the Senate side.

Mr. ST GERMAIN. Turning to the Franklin National situation, was there, in fact, an offer by Morgan Guaranty on the weekend, I think, of May 6 or 5 to acquire Franklin National?

Were you privy to that?

Chairman WILLE. I was not aware of any Morgan Guaranty offer, Mr. Chairman.

Mr. ST GERMAIN. I believe your testimony states that—I am sorry—Manufacturers Trust.

Excuse me.

Mr. MCGILLICUDDY. It was the president of Manufacturers Hanover.

Mr. ST GERMAIN. All right. Was there an offer by them?

Chairman WILLE. Not that I know of, Mr. Chairman.

Mr. ST GERMAIN. This was never related to you?

Chairman WILLE. No, sir.

Mr. ST GERMAIN. It was brought to our attention, I believe, as the result of an article in Fortune magazine. I am attempting to determine whether, in fact, there had been that offer.

Chairman WILLE. I think the Comptroller's testimony indicated last week that he was attempting to interest Manufacturers Hanover in an acquisition of Franklin which would not involve FDIC assistance of any kind. I am sure that, as a result of that, the context was a merger transaction, similar to the subsequent acquisition by the Chemical Bank of Security National on Long Island, which was also accomplished without FDIC financial assistance or guarantees.

Because we would not have been an essential party to that kind of resolution of the Franklin, it was not brought to my attention, and I was unaware of the discussions going forward that particular weekend.

Mr. ST GERMAIN. The European-American Bank that acquired the assets of Franklin is composed, I think, of six major foreign banks with total assets that are astronomical.

Do you know if Mr. Sindona was the director of any of these foreign banks who make up the consortium that actually owns European-American?

Chairman WILLE. I am quite sure he is not and was not, although I will check that for the record and supplement it for you, Mr. Chairman. None of those banks which are the parents of European-American were institutions chartered under the laws of Italy, and I rather doubt that Mr. Sindona had any official relationship with the six parent banks.

Mr. ST GERMAIN. Franklin National was not under the laws of Italy. He had a pretty strong relationship to Franklin.

Chairman WILLE. Well, he had a 20-percent stock interest; that is right. I do not believe that the import of your question is correct, but I will check it for the record.

Mr. ST GERMAIN. I am not trying to import anything. What I am trying to determine is whether or not Mr. Sindona did, in fact, have any relationship with any of these six banks.

Chairman WILLE. I do not believe he was a director, which was your first question. I am quite sure that he was not a controlling shareholder of any of the six. He may, as Governor Holland pointed out, have been a borrower at one or more of them, but I cannot confirm that for the record at this time.

Mr. ST GERMAIN. Did any of these banks, these six—and you are familiar with who they are—have any loans outstanding at any time to either the Franklin National Bank or to the Franklin National Corp.?

Chairman WILLE. Did any of the six banks have loans outstanding to Franklin?

Mr. ST GERMAIN. Yes.

Chairman WILLE. My guess is that they did, but I would have to ask our chief liquidator in New York that question. These are six major European banks. Franklin was a participant in many loan arrangements with major European banks and other U.S. banks. I would be very much surprised if there was not some loan relationship between some of these institutions and Franklin itself.

Mr. ST GERMAIN. Asking a prior question in reverse, did FDIC determine whether any of the directors of the European-American Bank family, those six banks, sit on any of the banks in which Mr. Sindona has or had any interest?

Chairman WILLE. I do not believe that particular relationship was correlated by the FDIC before the transaction.

Mr. ST GERMAIN. In other words, it was not looked into, you do not think?

Chairman WILLE. I do not have the information and do not believe that it was.

Mr. ST GERMAIN. Would you answer that for the record?

Chairman WILLE. Yes.

[The information referred to is contained in FDIC response to subcommittee dated September 3, 1975, may be found in appendix A.]

Mr. ST GERMAIN. Do any of the banks have loans outstanding to any of the banks which Mr. Sindona had a relationship? The prior question was Franklin and Franklin National. Now the question is, Do any of those banks have loans outstanding to any of the Sindona banks?

Chairman WILLE. Actually, my answer would have to be the same. I would be surprised if they did not. But I would have to check that for the record.

Mr. ST GERMAIN. And at the same time would you check the reverse? Did any of the Sindona banks lend any money to any of the six banks?

Chairman WILLE. On that score, I might not have any information whatever because the banks which Mr. Sindona controlled on the other side of the Atlantic were chartered by either Italy or Switzerland in my recollection and I doubt that information would be available to me in any form.

Mr. ST GERMAIN. And as you know, one-third of Franklin's total outflow of deposits occurred at the London branch. These evidently were very highly volatile funds. Meanwhile the assets of the London branch of 550 loans with an average maturity of 5½ years could not be liquidated without incurring to you greater losses than would have been incurred on the bank's long term domestic securities which carried a much lower rate of interest. The foreign branch deposits are not insured and so the FDIC had no responsibility toward the depositors in the London branch. Is that an accurate statement that foreign branch deposits are not insured?

Chairman WILLE. Well, you raise a very interesting and sensitive point, Mr. Chairman. The FDIC's statute——

Mr. ST GERMAIN. Oh, you know what the next question is going to be.

Chairman WILLE [continuing]. Talks about deposits which are payable in the United States and exclude from insurance coverage deposits payable only at overseas offices of U.S. banks. As to deposits that are payable both in the United States and abroad, there is a significant legal question not resolved by any court that I know of as to whether or not those are insured deposits in the event of a failure.

Mr. ST GERMAIN. At the present time, are those banks paying to FDIC, insurance on those funds? I hate to interrupt you but that was the question.

Chairman WILLE. At the present time the formula for insurance premiums is based on total domestic deposits and those types of deposits are not considered part of the assessment base.

Mr. ST GERMAIN. The foreign deposits?

Chairman WILLE. Yes; now, you may remember, Mr. Chairman, that some time ago I reported to you that the FDIC would be preparing a number of technical amendments to its own statute which would answer or try to clarify some of these types of questions which affect our day-to-day operations. That particular bill is ready and I hope that sometime during the course of the day it will be in your possession. And I would hope that you might see fit to introduce that on request of the corporation for consideration in the future.

It is basically a technical amendments bill, but on this particular point it would clarify the question you asked, and make it very clear that unless the deposit is payable exclusively in the United States and its various territories, it is not insured by the corporation.

Mr. ST GERMAIN. By the same token, did not FDIC elect to take on a larger role in the Franklin case than merely paying off depositors? Did it not take on the responsibility of repaying the Fed for the funds advance to replace the outflow of deposits in the London branch and other noninsured deposits by attempting to realize the value of at least the desirable portion of Franklin's portfolio including its foreign loans in short and long term securities?

Chairman WILLE. It is true that the actual set of agreements worked out in the Franklin situation, because of the international operations of the Franklin, went beyond those in any previous bank failure in which the FDIC played a role.

However, we are quite confident that the actions we took were legal and permissible under our statute and there are, as you pointed out in your other reference, reasons why the transaction took the form that it did. I tried to explain some of that in the white paper which was delivered last November and I would be glad to elaborate on why we did what we did with that particular Fed window loan.

The net effect of the transaction under which we took over the responsibility for paying the Federal Reserve window loan is that any risk of loss on that window loan is imposed on the insured banks of the country rather than on the general taxpayers. And that is because our funds are derived from the banking system through insurance premiums and income on part insurance premiums.

The Fed's surplus each year, as you know, is returned to the general Treasury and to that extent would have indirectly affected the general taxpayers of the country. We thought that between these two sources of funds it was only appropriate that the risks of loss be on the insured banks of the country.

Mr. ST GERMAIN. But, it is not conceivable that that type of action could eventually, unless it is covered by the legislation which you say you are sending up, have an effect upon the insurance being paid by the banks to FDIC? And as we are told about disclosure, if the banks have to keep those records there would be an added charge which will end up being paid for the depositors and borrowers of the bank. So, could this not conceivably increase the insurance premium to the banks covered by FDIC?

Chairman WILLE. Well, to the extent that there are losses in any bank failure, we must set aside a reserve for those losses and the effect of setting aside such a reserve is to increase the normal premium paid by the insured banks in the system. It is done on an annual basis and if there actually is a loss to the FDIC in the Franklin situation, yes, that will have some impact on deposit insurance assessments in the future and will tend to raise them.

We are not at the present time predicting any such loss.

Mr. ST GERMAIN. Mr. Rousselot?

Mr. ROUSSELOT. In your statement regarding——

Chairman WILLE. I might say, we have not referred to that statement before this line of questioning began. I will assume you have read it and I do not need to do that but there is quite a bit of information in that statement as to the status of the U.S. National and Franklin receiverships. I will say, only with regard to U.S. National, that it is a thicket of litigation right now and that the final outcome of that may be years away.

Mr. ST GERMAIN. I think you said 9 years, did you not?

Chairman WILLE. Well, it very well could be that, with appeals and everything else. But the Franklin liquidation is proceeding quite differently and, at least so far, we have been making significant collections. We now have, on the Franklin assets that we are administering, collected something over $400 million and are bringing down that Federal Reserve window loan substantially on a week-by-week basis. I will not go into the other material with regard to the Franklin. It is on the first five pages of my statement on the two receiverships.

I am sorry, Mr. Rousselot.

Mr. ROUSSELOT. On the great date that we have had put before us many times of May 8, was it your judgment that Franklin was not solvent?

Chairman WILLE. I had no judgment on May 8 as to the solvency of Franklin.

Mr. ROUSSELOT. How about May 9 or 10 immediately following?

Chairman WILLE. My only view is that so long as the Federal Reserve system was willing to provide liquidity to the Franklin National Bank, it was a solvent institution. The definitions of insolvency vary. One says that a bank is insolvent when the value of its liabilities exceed the value of its assets.

Mr. ROUSSELOT. Let us take your definition; do you think now that you look at it, that it was really solvent after its initial announcements of May 8, say around the 12th, 15th?

Chairman WILLE. I do not believe Franklin National Bank was insolvent on a balance sheet basis at anytime. And it may not have been insolvent even at the time it closed on a balance sheet basis. But as the Comptroller pointed out in his certificate of insolvency, the inability to meet demands when they become due, that is, the liquidity definition of insolvency can apply and, in fact, Franklin would have been insolvent at anytime the Fed would have failed to provide it additional liquidity assistance.

The Comptroller made his determination that he would not await a specific date for this to occur and he accordingly declared the bank insolvent on October 8.

Mr. ROUSSELOT. What was the quality of the collateral?

Chairman WILLE. The quality of the collateral that we have obtained from the Franklin National Bank is better than most observers were claiming back last May, at least in our judgment so far. The total assets of the Franklin Bank were about $3.6 billion and European-American selected, as the asset side of its transaction, about $1.4 billion in those Franklin assets which left a considerable volume of perfectly credit worthy loans and other assets on Franklin's books which we are now attempting to collect.

Looking at the loss classifications and the doubtful classifications and the substandard classifications, the volume of assets that we have to collect at least on a book value basis should be adequate to repay in full the Federal Reserve window loan.

Now, obviously, in the assets that we have, there is going to be a significant amount of loss, but I do not think at this point it will affect our ability to repay the Fed window loan without loss to the FDIC. The chief liquidator of our Franklin receivership is here and I might just ask Mr. Hill if he wants to supplement that and comment for the record.

Mr. HILL. I think that is entirely correct.

Mr. ROUSSELOT. Well, you got the portfolio on October 8, the collateral.

Chairman WILLE. On October 8 the Fed released the collateral that it had for the window loan, to the extent a release of its lien was necessary for the transfer of assets to European-American or for our own liquidation efforts, in return for a promise from the FDIC fund to make that window loan good over a 3-year period.

Mr. ST GERMAIN. You did not get that collateral. That collateral went to European-American did it not?

Chairman WILLE. No, what happened was that with respect to the assets left behind by European-American the collateral lien of the Federal Reserve Bank is automatically removed as and when this is necessary for our liquidation efforts. Now, European-American did not select all of the assets. It eventually took assets from the collateral that the Fed had; some of the assets that they selected were not collateral at the Fed. With respect to the assets which were at the Federal window as collateral, that collateral lien remains in existence with respect to the assets not selected by European-American until such assets are liquidated by FDIC.

Mr. ROUSSELOT. Well, Mr. Chairman, I guess we have to go vote.

Chairman WILLE. I think the dollars involved here might be important because the Fed had collateral that was worth about $2.2 billion for a loan that was significantly less than $2.2 billion, and European-American only picked up $1.4 billion of assets. So, there had to be some surplus of assets placed as collateral at the Fed which were not selected by European-American. There was no release of the collateral interest that the Fed had with respect to the assets that FDIC is administering.

Mr. ROUSSELOT. When did you actually take possession of the collateral?

Chairman WILLE. This was a steady process with regard to the assets not selected by European-American over a 6-month period of time. Certain types of assets were quickly transferred to FDIC jurisdiction including principally the securities portfolio not selected by European-American. That came over very fast. Loans took a little bit longer and there was a time sequence in the agreement by which European-American had to select and reject certain proportions of the total amount. They have not finally completed that selection process but they will by the end of July.

Mr. ROUSSELOT. I guess to pursue my other questions would take too long.

Mr. ST GERMAIN. Chairman Wille, we are now going to vote on a number of suspensions and, therefore, we will be in recess until 2 o'clock.

Would that fit in with your schedule?

Chairman WILLE. That would be fine, sir.

Mr. ST GERMAIN. The subcommittee will be in recess until 2 o'clock.

[Whereupon, at 1 p.m., the subcommittee recessed to reconvene at 2 p.m. the same day.]

AFTERNOON SESSION

Mr. ST GERMAIN. The subcommittee will come to order.

Chairman Wille, we have received your additional submission of the recommendations on regulatory reform. At this point, without objection, we will place it in the record in its entirety, and if you would like to make additional comments or highlight it, then we can get back to a continuation of our previous line of questioning.

[Testimony resumes on p. 1200.]

[The information referred to follows:]

[The "Comments on Bank Regulatory Reform," submitted by Chairman Wille follows:]

FDIC
FEDERAL DEPOSIT INSURANCE CORPORATION

NEWS RELEASE

PR-58 (7-21-75)

COMMENTS ON BANK REGULATORY REFORM

Submitted by

Frank Wille, Chairman
Federal Deposit Insurance Corporation

to the

Subcommittee on Financial Institutions,
Supervision, Regulation and Insurance
Committee on Banking, Currency and Housing
House of Representatives

July 21, 1975

55-937 O - 75 - pt. 2 - 33

For the past six months, a top-level staff group within the Federal Deposit Insurance Corporation has been attempting to identify significant and demonstrable points of friction within the present Federal bank regulatory structure which might justify recommendations for major Congressional reform. That group has also reviewed the Federal supervisory experience over the past five years in dealing with large problem banks and a number of large bank failures to determine if that experience might justify similar recommendations. Finally, the group has attempted to analyze the potential advantages and disadvantages of a single Federal bank regulatory agency which might exercise all of the powers which are today vested in the Comptroller of the Currency and the FDIC as well as the examination and supervisory powers presently vested in the Federal Reserve System.

Stated succinctly, the group has identified only two significant and demonstrable points of friction within the present structure: one relating to different agency attitudes toward bank acquisitions under the Federal Bank Merger Act, the other relating to the overlapping authority of the Federal Reserve System in connection with one-bank holding companies in which the only bank subsidiary is either a national bank supervised by the Comptroller of the Currency or a nonmember bank supervised by some State banking department at the State level and the FDIC at the Federal level. As the Subcommittee will recognize, neither of these items had anything to do with the failure or near failure of United States National Bank, Franklin National Bank or Security National Bank. The group further found that the existing

agency structure was not a significant factor in any of the recent failures which have been so widely publicized and that a different bank agency structure at the Federal level would not necessarily have prevented any of them. This finding reflects, I am sure, the truism that no agency will be any better than its leadership or the men and women who staff it.

If recent bank failures provide no justification in fact for major bank agency reform at the Federal level, the case for a consolidated, all-powerful bank agency must rise or fall on the weight which Congress attaches to its respective advantages and disadvantages. The creation of such an agency would be such a far-reaching and dramatic change in the existing order of things that I believe the Subcommittee might find useful our staff's summary of the pros and cons of such an agency.

ARGUMENTS IN FAVOR OF A SINGLE, ALL-POWERFUL FEDERAL BANK REGULATORY AGENCY:

1. Simplification of Administration; Improved Internal and External Communication. A single agency would provide a single focal point for Congressional and Administration contact on matters of bank regulation and supervision. Additionally, all public inquiries on matters of banking and bank regulation could be addressed to the single agency. All agency actions and decisions would originate, presumably, from a single Administrator or a single Board. Instead of 14 FDIC regions, 14 National bank regions and 12 Federal Reserve Districts (few of which are today identical) a much simpler regional setup could be achieved.

2. Elimination of Conflicting Goals. The fact that the scope of responsibilities differs among the three Federal banking agencies results in a number of internal conflicts with respect to the handling of supervisory problems. This is thought by many to be a particular problem for the Federal Reserve System whose principal function is the formulation and implementation of monetary policy. These observers believe that where the implementation of monetary policy goals is combined with regular bank examination and supervision, the former will always be viewed as more important than the latter and will prevent a consistent, evenhanded approach to matters of bank supervision. This potential problem would be reduced by setting up a single bank regulatory agency divorced from monetary policy responsibilities.

3. Economy and Efficiency of Operation. Considerable economy could be achieved by combining the legal, research, training and other Washington Office functions of the three existing bank regulatory agencies. There would be a reduction in senior agency staff time spent communicating with and keeping current with the activities of other agencies.

More efficient use could be made of examiner time, training and specialized capabilities. A single agency would eliminate differences in the form and substance of reports of examination and would be able to issue uniform instructions to all examiners. Travel time of examiners could be reduced, and in many instances where it has not heretofore been feasible, all banks within a particular community could be examined simultaneously. A single agency could make more efficient use of specialized expertise to

handle complicated credits and to concentrate on such areas as trust activities, international departments and foreign offices of insured banks, certain data processing and other areas of automated activity, and compliance with Federal and State statutes in the consumer protection area. Economy could be achieved through a single training program which would not only reduce existing duplication, but facilitate the development of more advanced and specialized training.

A single agency would eliminate differences in reports filed by insured banks, thereby eliminating some duplication or redundant effort in administering and processing such reports, in computer costs and in publication costs.

4. Elimination of Actual or Potential Policy Conflicts. A single agency would bring uniform treatment to all insured banks in such matters as rules, regulations, standards and procedures. For example, a single, rather than three separate guidelines on a subject, such as insider transactions, could be effected. Also, uniform application of statutory powers, such as cease and desist powers, would result. Banks would also be subject to greater uniformity with respect to loan classifications, policies on capital adequacy and other areas related to bank examinations.

Consolidation would result in a single policy on chartering, branching and mergers. */

*/ The Comptroller is the only Federal banking agency having chartering and branching authority, but the FDIC and to a lesser extent the Federal Reserve each play an important role in the establishment and branch expansion of State banks.

5. Facilitating the Handling of Failing Banks. It has been alleged that the involvement of three Federal banking agencies in the handling of some failing banks prolongs and overly complicates an appropriate resolution of the problem. A single agency probably could reduce the time involved. Under present arrangements, it is difficult to consider all alternatives more or less simultaneously, because the three agencies have somewhat different powers related to solving these problems (e.g., the Comptroller has somewhat more flexibility in arranging a National bank merger which does not require special Government financial assistance or guaranties, while the Federal Reserve can provide liquidity assistance and the FDIC can provide other types of financial assistance to insured banks regardless of charter).

6. Improved Regulation of Bank Holding Companies, Their Affiliates, and Certain Other Bank Relationships. A single Federal bank agency would have responsibility for examining banks and their holding company affiliates, thereby facilitating a more complete picture of the entire operation and the assessment of the overall risk exposure of the bank(' and the holding company. Under present arrangements the Federal Reserve has certain regulatory authority over the activities of holding companies whose principal assets may be banks subject to the regulation of the other two Federal banking agencies.

When Congress addressed the bank holding company issue in 1970 and concentrated regulatory authority within the Federal Reserve, Congress was primarily concerned with the range of permissible nonbank but bank-related activities to be made available to such holding companies. In more

recent years issues related to financial arrangements of holding companies and their impact on bank risk have become more important than permissible activities, and the present regulatory arrangement does not seem to be well suited to deal with these issues. Even apart from the holding company framework, there exist in today's banking system many complicated financial arrangements associated with joint ventures and shared credits where the present Federal regulatory structure makes it difficult to get a complete picture of a bank's risk exposure in a particular transaction. A single agency could ameliorate this situation.

7. Gains to Banks and Bank Customers from a Single Federal Agency. Differences in regulations, in examination standards and reporting requirements among the Federal banking agencies may result in different treatment of similar situations and, as a result, in some inequities. In addition, there are costs imposed on the banks and the public in having to work with and understand these differences.

8. Adjusting to a Rapidly Changing Environment. Rapid changes have been occurring in banking in recent years -- for example, in such developments as the growth of bank-related activities across State lines through holding companies, innovations in the payment system and the growing importance of international operations in the activities of large banks -- and there is no reason to assume that this process will decelerate. A single Federal banking agency may be in better position to command the technical and specialized

resources and to exercise the administrative flexibility necessary to cope with this changing environment.

ARGUMENTS AGAINST A SINGLE, ALL-POWERFUL FEDERAL BANK REGULATORY AGENCY:

1. The Present System Has Worked Reasonably Well. Despite what appears to be a cumbersome structure on paper, the present system, for the most part, has worked well. In considering the substantial revision necessary to bring about a single all-powerful agency, it is important to realize that this would involve a considerable disruption in orderly operations and that it might take years for a smooth-running agency to be established. The cost of this disruption should be weighed against the assumed benefits of such a single agency.

2. Such an Agency Will Not be a Panacea. A single all-powerful agency will not assure uniform and quality performance in all examinations and in all supervisory activities. Quality differences will persist. Our own study of the examination process suggests that there are regional and quality differences within each agency which may exceed interagency differences. With respect to improving the flow of information, greater interagency coordination, even within the present system, might accomplish much of what could be accomplished through a single agency. Under the present system there may be considerable room for improving examination techniques and improving the allocation of supervisory resources, and we have been

devoting considerable effort in this direction at the FDIC. However, a single agency will not, by itself, bring about such improvements.

3. Concentration of Power and the Elimination of Regulatory Choice. Creating a single, all-powerful agency would concentrate an extraordinary amount of power within a single unit of government. Banks and the public could be subject to relatively arbitrary or relatively inflexible behavior. One advantage of the present system or one containing more than a single agency is that such a system provides Congress and the agencies themselves with an informed group of potential critics which have no vested financial interest in the outcome of a particular course of action. This is a luxury that has not always been available in the case of other Government regulatory agencies, whose critics generally have come from the industry being regulated.

While the existing Federal and State agencies have at times appeared to be competing in their attempts to accommodate banks under their immediate supervision, differences in agency policy, sometimes influenced by the threat of a shift in supervisor(s), have also performed a positive role in limiting unreasonable, inflexible or arbitrary behavior on the part of one or more of these agencies. Not all "agency shopping" has been contrary to the public interest. Indeed, there are numerous instances where the opposite has occurred, where the initial agency was not sufficiently receptive to public need or changing practice or where it was too strongly influenced by the existing banking establishment, as for example in its chartering or branching policies. In such instances a change of supervisory authority by the dissatisfied

bank or its organizers may well have been in the public interest. The availability of a choice among supervisory authorities has, of course, been the lifeblood of the so-called dual banking system in this country.

4. Benefits of Diversity. While a single, all-powerful agency could more readily support specialized training and research, this may be outweighed by the potential benefits from the diversified and somewhat independent efforts of three separate Federal agencies, just as it is by the diversified and independent efforts of some State banking departments. There may be a greater tendency to experiment and to be receptive to change with three such agencies than with only one, since the odds are high that at least one of the three might be receptive to experimentation and change at any point in time. This is likely to be the case not only from the standpoint of developing examination and supervisory techniques, but also from the standpoint of accepting and encouraging innovation in banking practices. In the past this potential for flexibility and experimentation has produced substantial public benefit, and it is likely to do so in the future.

* * * * *

Director LeMaistre and I */ believe it would be a grave mistake to consolidate the existing powers of all three Federal bank agencies into one single, all-powerful agency of the type described, largely because we believe

*/ The Comptroller of the Currency, who serves ex officio as the third member of the FDIC Board of Directors, has previously expressed to the Subcommittee his views on the general subject of bank regulatory reform, and reference is made to pages 1-5 of his statement of July 17, 1975, for an accurate statement of his position.

it would eliminate any meaningful choice between the regulatory options now available to the nation's insured banks. We believe that over the years the banking public has benefitted from the flexibility in chartering and supervision which that choice entails and that it should not be lightly discarded.

Such a consolidation represents one extreme, however, of the broad spectrum of proposals which might appropriately be considered by the Congress if it determines that significant change should be made in the existing structure of bank regulation at the Federal level. We believe, for example, that it may be possible to achieve many of the advantages of greater centralization without giving up the meaningful regulatory choice to which we have referred.

We have no specific proposal to lay before you today that would, in our judgment, accomplish this intermediate result, but we have asked our staff to continue their efforts to see if a feasible and detailed proposal can be developed that would r[illegible] our two objectives as well as the needs of other legitimate regulatory interests, such as the formation and implementation of monetary policy. Should those efforts prove successful, you may be sure that the results will be brought to the Subcommittee's attention.

I would conclude by stating that the FDIC is not wedded to the existing bank regulatory structure. It is quite prepared to see its own powers and responsibilities significantly changed if the Congress believes such changes are likely to lead to a more rational system of bank regulation in behalf of the American public. This is a complex area, however, for legislative reform, and I would urge the greatest care and deliberation on the part of the Subcommittee as it proceeds.

Chairman WILLE. Well, there are two things we did not discuss at all this morning. One was a sheet of paper labeled "Legislative proposals under FDIC consideration as a result of the failure of U.S. National Bank and related enforcement problems."

Mr. ST GERMAIN. Without objection, that particular statement will be put in the record.

[Testimony resumes on p. 1209.]

[The information referred to follows:]

FDIC

FEDERAL DEPOSIT INSURANCE CORPORATION

NEWS RELEASE

PR-57-75 (7-21-75)

Legislative proposals under FDIC consideration as a result of the failure of United States National Bank and related enforcement problems

Presented to the

Subcommittee on Financial Institutions,
Supervision, Regulation and Insurance
Committee on Banking, Currency and Housing
House of Representatives

by

Frank Wille, Chairman
Federal Deposit Insurance Corporation

July 21, 1975

55-937 O - 75 - pt. 2 - 34

This statement outlines a number of legislative proposals the FDIC is considering which might curb some of the abuses that led to the downfall of United States National Bank and have or could lead to the failure of similarly operated banks.

I. AFFILIATES: A broader definition of affiliate for lending purposes

USNB, which was in fact controlled by C. Arnholt Smith, extended massive credit to other enterprises controlled by Smith, yet these credit extensions apparently did not violate the provisions of § 23A of the Federal Reserve Act limiting loans to "affiliates" of member banks (made applicable to non-member banks by § 18(j) of the Federal Deposit Insurance Act). Section 23A incorporates the definition of "affiliate" found in Section 2a of the Banking Act of 1933 (12 U.S.C. § 221a). As presently written, Section 2a limits the term "affiliate" to those entities which are controlled by shareholders who control more than 50 percent of the shares of a bank's voting stock, and Smith himself did not directly control a majority of the voting shares of USNB. We believe that this definition should be changed to encompass shareholders who have actual control over the management or policies of a bank even though they own less than a majority of its voting shares.[1/]

This change was previously suggested by the Comptroller of the Currency in his prepared statement before this Subcommittee on December 11, 1974.

1/ The term "affiliate", as defined in Section 2a, is used in other sections of the Federal Reserve Act as well as Section 23A. Each of those sections will be separately examined to determine whether the recommended broadening of the definition of "affiliate" is similarly desirable.

II. CONGLOMERATES: Tighter limits on lending to entities under common control

Although there are federal and state laws which limit loans to a single borrower, many corporate borrowers have been able to avoid such limits through the simple expedient of having each of their subsidiaries borrow separately from the same bank, with the parent company refraining from any direct borrowing from that bank. The danger is that laws or regulations which treat corporate subsidiaries as separate entities for bank lending limit purposes will result in aggregate excessive loans to ostensibly separate entities which are in reality part of a single enterprise. When that enterprise fails, normally the loans to all of the entities go "sour".

For example, USNB extended credit to the Westgate-California conglomerate in amounts far in excess of the legal limit imposed on loans by a national bank to any one borrower (12 U.S.C. § 84). It was able to do so because the parent company (now in Chapter 10 proceedings) didn't borrow directly. In construing § 84, the Comptroller of the Currency has ruled that obligations of subsidiary corporations are generally not considered obligations of the parent if the parent corporation is not itself borrowing from the same bank (12 C.F.R. § 7.1310), and this construction in the view of most lawyers is supported by the language of the statute.

To counter this problem, the FDIC favors changes in both federal and state lending limits, where necessary, which would allow the supervisory authorities to treat loans to entities under common control as loans to a single borrower.

III. INSIDERS: Tighter limits on lending to insiders and their related business interests

Lending limits should prevent banks from incurring undue risks by lending excessive amounts to insiders and their related business enterprises. A bank may be less subject to the restraints imposed by prudence and sound judgment when making loans to these insiders and their related interests than it would be in making loans to unrelated individuals or business enterprises.

In line with Governor Holland's testimony last Wednesday, we recommend that § 22 of the Federal Reserve Act (12 U.S.C. § 375a) be amended so as to cover directors and controlling shareholders of a member bank in addition to its executive officers, and to business enterprises which such directors, controlling shareholders and executive officers control. We also agree that loans to these individuals should be aggregated with loans to companies controlled by them for the purpose of applying state and federal lending limits. Since many states impose no legal restraints on loans to a bank's own executive officers, directors or controlling shareholders, we recommend that Section 22 of the Federal Reserve Act be extended to encompass those State-chartered banks which are insured by the FDIC but do not belong to the Federal Reserve System.

Parenthetically, I might add that the FDIC is considering regulations which would impose on banks tighter internal controls and recordkeeping requirements for transactions with insiders. We plan to publish these proposed regulations for public comment within the next few weeks.

IV. FINES: Administrative fines for major banking law violations

A special problem has to do with the absence of penalties for violations of major federal banking laws, such as §§ 22 and 23A of the Federal Reserve Act. I previously recommended that § 22 be extended to cover insured nonmember as well as member banks. Section 23A already applies to insured nonmember banks by virtue of § 18(j) of the Federal Deposit Insurance Act. Neither section includes any provision for a fine in the event of its violation, yet both sections are important in preventing the kinds of abuses often found in problem banks.

We recommend that Congress authorize the appropriate bank regulatory agency to assess a fine against any bank or individual willfully violating § 22 or § 23A, or willfully refusing to obey any lawful regulation issued pursuant thereto. Such fine would be in the nature of a civil rather than a criminal penalty and would vary in amount, within the maximum set by law, at the discretion of the agency.

We recognize the severity of this remedy but feel that it often constitutes the only effective method of deterring harmful violations. Termination of a bank's insurance has long been recognized as too severe to be used in any but extreme situations. Cease and desist proceedings are useful but the threat of a cease and desist order, standing alone, has not always proved to be a sufficient deterrent to those who would willfully violate laws or regulations. Hopefully, the threat of a fine would deter conduct that could cause irreparable injury to a bank.

We also recommend the imposition of a fine for the willful violation of any effective and outstanding cease and desist order issued by an agency under

§ 8(b) or § 8(c) (12 U.S.C. §§ 1818(b) and (c)) of the Federal Deposit Insurance Act where the order has become final. In this case, the fine would be imposed for each day that the offending bank or individual willfully refuses to obey the order. The imposition of a fine for violating a cease and desist order which has become final would serve to emphasize the gravity of such an order. Under § 8(k) (12 U.S.C. § 1818(k)), a cease and desist order does not become final unless entered into by consent or until the time has run for filing a petition for review with the appropriate U. S. court of appeals and no petition has been filed or perfected, or the petition so filed is not subject to further review by the Supreme Court. In either event, the party must have exhausted the administrative and judicial remedies afforded him under the Act. If the party then continues to disobey an order, the appropriate agency can apply to the proper U. S. district court to secure its enforcement. However, the threat of court enforcement and possible contempt proceedings should not be the only deterrent at this point. The party has been given every opportunity to have his day in court. He should not be allowed to further impede the effect of the order simply to secure another delay and should be subject to a substantial monetary penalty for each day that he does so.

V. REMOVAL: Individuals who willfully disregard the safety and soundness of an institution

As you know, § 8(e) (12 U.S.C. § 1818(e)) of the Federal Deposit Insurance Act authorizes the removal of a bank director or officer who has engaged in a violation of a law, rule or regulation, participated in an unsafe or unsound practice, violated a final cease and desist order, or breached his fiduciary duty; but only where his actions also involve personal dishonesty and are

seen as causing substantial financial loss to the bank or damage to its depositors. This effectively bars the removal of an officer or director who has repeatedly demonstrated gross negligence or willful disregard for the safety and soundness of his bank, thereby causing it substantial financial injury, but who has not been shown to have engaged in any act amounting to personal dishonesty.

Although we recognize the effort on the part of Congress to shield those who are innocent of any personal wrongdoing from arbitrary or capricious administrative action, we feel that some effort should be made to balance the interests of the individual bank officer or director against those of its depositors and shareholders, and ultimately the Federal deposit insurance fund. This can be done by adding to the Act as an alternative to the standard of personal dishonesty, a new standard which would recognize the need to remove those whose reckless conduct threatens the financial safety of their insitutions. Since removal under § 8(e) is an administrative remedy which may not be put into effect until a hearing has been afforded the party in question, providing him with an opportunity to put on his defense, he is adequately protected against arbitrary and capricious administrative action. In addition, he has the right to petition a court of appeals to modify or set aside the removal order.

VI. CEASE AND DESIST: Extension of order to certain persons

Our experience suggests that a bank may be harmed not only by the misconduct of its own management but also by the misconduct of others who are in a position to influence its affairs. However, it is often difficult to reach such persons through a cease and desist proceeding brought against the bank itself.

Section 8(b) (12 U.S.C. § 1818(b)) of the Federal Deposit Insurance Act empowers the appropriate federal banking agency to bring a cease and desist proceeding against a bank that is engaged in a violation of a law, rule or regulation, or an unsafe or unsound practice. We recommend that § 8(b) be amended to expressly include persons such as directors, officers, controlling shareholders and others participating in the conduct of the affairs of the bank. This would enable the appropriate agency to control the participation in the affairs of a bank of those persons who have either violated a law, rule or regulation, or engaged in an unsafe or unsound practice, or participated with others in such violations or practices.

Chairman WILLE. That contains six specific legislative proposals that we think are of significance for all the bank regulatory agencies in trying to prevent a situation such as we had in the U.S. National Bank.

The comments on bank regulatory reform which I have submitted contain a little bit of summary as to the efforts which the FDIC and its staff have been engaged in over the last 6 months to analyze the problem of the present regulatory structure with three agencies, the Comptroller of the Currency for National Banks, the Federal Reserve System for State member banks and the FDIC for nonmember banks at the Federal level. Our consideration did not go specifically into the question of the relationship between these different agencies and the 50-State banking departments around the country which also regulate State-chartered banks, but we were looking at those points of significant friction within the present structure at the Federal level. There are a number of differences which we do not consider significant, most of which are based either on differing statutes or personalities involved, or just plain differing points of view as to matters on which we concede that reasonable men will differ.

We found in this survey significant and demonstrable points of friction in only two areas that we think the subcommittee might wish to look into further. One related to different agency attitudes toward bank acquisitions under the Federal Bank Merger Act, and the second related to the overlapping authority which the Federal Reserve System has had since 1970 in connection with bank holding companies in which the only bank subsidiary is not a State member bank regulated and examined by the Federal Reserve, but rather a national bank supervised by the Comptroller or a nonmember bank supervised at the State level by a State bank department and by the FDIC at the Federal level.

Now neither of those two items had anything to do with the failure or near failure of U.S. National, Franklin National, or Security National, and we looked into the question of whether the present agency structure was a significant factor in any of the recent failures which have been so widely publicized over the last 2 years and whether or not in our judgment a different bank agency structure would have prevented those particular failures.

We came to the conclusion that the agency structure today was not a significant factor in those failures and that a different structure might not necessarily have prevented them. The arguments for a consolidated, all-powerful agency at the Federal level which would combine the present powers of the Comptroller of the Currency and the FDIC, as well as the supervisory and examining functions of the Federal Reserve System insofar as banks and bank holding companies are concerned, were also analyzed by the FDIC's staff and the major portion of this paper contains the more significant pros and cons which they found in favor of or against a single, all-powerful Federal bank regulatory agency.

The conclusion, which Director LeMaistre and myself have reached with regard to this matter, at least at this juncture, starts at the bottom of page 9, and I think I might just read the last few paragraphs of this statement.

Needless to say, we are not speaking for the Comptroller of the Currency, who is the third member of the FDIC Board of Directors. He submitted his separate views last week, and you have those at the very beginning part of his statement of July 17.

Quoting from the bottom of page 9 of my own statement, I say:

> Director LeMaistre and I believe it would be a grave mistake to consolidate the existing powers of all three Federal bank agencies into one single, all-powerful agency of the type described, largely because we believe it would eliminate any meaningful choice between the regulatory options now available to the Nation's insured banks. We believe that over the years the banking public has benefited from the flexibility in chartering and supervision which that choice entails and that it should not be lightly discarded.
>
> Such a consolidation represents one extreme, however, of the broad spectrum of proposals which might appropriately be considered by the Congress if it determines that significant change should be made in the existing structure of bank regulation at the Federal level.

In other words, there are some types of consolidation and there are other types of consolidation.

> We believe, for example, that it may be possible to achieve many of the advantages of greater centralization without giving up the meaningful regulatory choice to which we have referred.
>
> We have no specific proposal to lay before you today that would, in our judgment, accomplish this intermediate result, that is an intermediate position between the extreme of a complete consolidation and of the existing status quo, but we have asked our staff to continue their efforts to see if a feasible and detailed proposal can be developed that would meet our two objectives as well as the needs of other legitimate regulatory interests, such as the formation and implementation of monetary policy.
>
> Should those efforts prove successful you may be sure that the results will be brought to the subcommittee's attention.

I would conclude by saying that the FDIC is not wedded to the existing bank regulatory structure. It is quite prepared to see its own powers and responsibilities significantly changed if the Congress believes such changes are likely to lead to a more rational system of bank regulation in behalf of the American public.

The whole area of bank regulatory reform is a complex one, and I would urge the greatest care and deliberation on the part of the subcommittee as it proceeds, just as we at the FDIC will proceed ourselves with the greatest care and deliberation in working out more specific recommendations during the latter part of the summer.

Mr. ST GERMAIN. Thank you, Mr. Chairman, and thank you for that statement and the one which incorporates legislative proposals. It is certainly going to be of great assistance to the subcommittee and its membership in its deliberations and in the ongoing FINE study. We will also look forward to the other recommendations which you stated would be developed in a short period of time.

Earlier we had been discussing the question of the foreign deposits of Franklin and other similar institutions. This is one of the items you mentioned in reference to legislative recommendations.

Now perhaps this question is premature but when one looks at the growth rate of international banking and the number of financial institutions that have established foreign branches, which essentially are outside the scope, supervision, and regulation of our domestic regulatory agencies. Serious thought should be given to the insurance concept as far as these deposits in the foreign branches are concerned.

Do you feel that there is also call for additional supervision and regulation and reporting because my information is that reporting is very scant by the foreign branches of our domestic institutions. I recognize naturally that there are limitations that are imposed by some of the governments of the nations in which some of these branches are established?

Chairman WILLE. Well, there is no doubt that the international activities of American banks create risk exposures for the parent bank with which the Federal deposit insurance fund must be concerned.

In the case of the FDIC itself, I think it is important to recognize some characteristics about the group of banks which we regulate. We actually, in the nonmember bank category, have very few banks with full service international branches. Our banks run up from very small banks to over a billion dollars on the commercial bank side. We have approximately 200 nonmember banks that we examine regularly which are between $100 million and a little over $1 billion. We have only two banks—my most recent information indicates—with full service overseas branches: One in London, and that is the Bank of Tokyo Trust Co. in New York, a nonmember bank, and one in Paris, of First Empire Bank-New York, also a nonmember bank.

Curiously, the FDIC's statute does not require a nonmember bank to obtain the permission of anybody before obtaining a foreign subsidiary or before opening a foreign branch. That, too, is part of our technical amendments bill, which you will be receiving later this afternoon. It seems to me a clear oversight and reflected an assumption a few years back that the only banks likely to open such offices would be member banks of the Federal Reserve System.

Mr. ST GERMAIN. EFTS was a concept that was not contemplated for a long period of time.

Chairman WILLE. Quite true, and what we have seen is that banks in this area of $100 million to $1 billion in deposits are increasingly nonmember banks. We have more State chartered nonmember banks in that particular group that we examine than the Fed does in the State member bank group, and that is true of every size category below $1 billion. It is only in the group above $1 billion that the Fed has had significant exposure and experience with regard to international operations. Now I would not by any means compare our own experience in the international field with theirs or with the Comptroller's. This particular omission in law should be corrected, and I am sure that the subcommittee in due course will pay attention to that.

Because of the developing interest of nonmember banks in the international arena, we have been developing additional training requirements for our own examiners so that they can keep abreast of international financial activity. We are developing that kind of a program with the Comptroller's office and with the Federal Reserve System on a cooperative basis.

We are also tapping the long years of experience of the major American banks with international activities who are trying to be helpful and cooperative to us in that training effort.

Mr. ST GERMAIN. Does the FDIC maintain any overseas offices?

Chairman WILLE. We have no overseas office at the present time. The other branches that our nonmember banks have are mostly window

offices in the Bahamas or the Cayman Islands. They are agencies conducted in the Bahamas, administered by other banks generally or other agents. They are Eurodollar windows, in effect, where loans in the Eurodollar market can be made and deposits received. As I say, the only full service branches overseas that any nonmember banks have at the present time are this London office of the Bank of Tokyo Trust Co., and the Paris office of First Empire Bank-New York.

We expect more in the future and we have to be prepared for that development and are doing our best to get prepared.

In our receivership activities, the very first bank that had a full-service overseas office that failed was the Franklin, so that at least our own exposure with regard to these types of full service overseas branch offices is quite recent.

I agree with you fully that the reporting requirements presently imposed on American banks with overseas activities, whether they are member or nonmember banks, is inadequate for the regulatory job that we are being asked to perform. We have been discussing that particular matter with the Securities and Exchange Commission, which recognizes that their own past disclosure standards for bank holding company registration statements also have not provided the public with the information that it ought to have with respect to these operations.

We are on a cooperative basis, the three bank agencies and the SEC, exploring considerably greater disclosure on a regular basis as to the foreign operations of American banks.

I think I will stop there.

Mr. ST GERMAIN. Well, not as a question but I think more as a comment that goes along with your commentary we find now that, the operation of these foreign branch banks can have a very serious impact on the stability of the parent institution here in the United States.

Chairman WILLE. There is no doubt about that and I can vouch for the fact that both the Federal Reserve and the Comptroller's Office are stepping up their own surveillance of international activities of the banks under their jurisdictions.

Mr. ST GERMAIN. Am I correct in assuming that the FDIC does receive from the Comptroller a list of problem institutions?

Chairman WILLE. Each of the other two agencies maintains some identification for problem institutions. I think the Federal Reserve has such a list for State member banks, but I do not know if the Comptroller maintains such a list for national banks. I find it hard to believe that all the problem banks are kept in one's head, but nevertheless each of the other two agencies does have banks that they watch more closely than others.

With respect to bank supervision and examination, we receive the names of those banks and the reports of examination which relate to them, when the Comptroller reaches that determination, and we do our own evaluation to determine whether or not the same banks should be assigned a place on the FDIC's problem list, which includes not only our own banks but State member banks and national banks. We have also in recent years been reviewing the reports of examination of all national banks and State member banks with more than $100 million

in deposits. In other words, we are reviewing the reports of examination regularly for all of the major banks in the country.

In addition, we spot check the reports of the remaining 4,200 national banks and the remaining 1,000 State member banks that might not fall into the over $100 million categories. We have in the past had some delays in receiving completed reports of examination particularly with regard to national banks. I have discussed this matter directly with Comptroller Smith and I believe that the speed with which we are getting completed reports of examination has improved significantly and will continue to do so.

Mr. ST GERMAIN. Would you anticipate that the expediting of these reports would be even more effective in those areas for banks where there have been adverse reports by the examiner? I understand that since the experience in USNB, there is now a more direct line of communication to the Comptroller's Office, and the Fed, and, as I say, they have more expeditiously become aware of problem banks and what the problems are as a result of the examiners' reports. In addition, they plan to examine those banks with more frequency. Do you also get expedited reports on these problem banks that are being identified under this new system?

Chairman WILLE. Identified, that is by the Comptroller or the Federal Reserve?

Mr. ST GERMAIN. Yes; by the Comptroller and/or the Fed.

Chairman WILLE. I would say that when a determination is made by those two agencies that a bank in question is worthy of special supervisory attention and is a problem bank, yes, we obtain that identification rather promptly from the examining agency. I think the question we at the FDIC still have is knowing whether or not we have received all the information we should on banks which may become problems in a few months or years. In other words, once it is identified as a problem, it is easy to track and follow. If it is not identified as a problem, the information we get is not as systematic as it is for problem banks that are national banks or State member banks.

Mr. ST GERMAIN. With respect to a problem bank, you mentioned that the Comptroller called you in on Franklin at a given point in time—I think it was May 12 or something of this sort, I could be in error.

Chairman WILLE. He notified me that the bank would be issuing a press statement as to its foreign exchange losses the day before it did, so that as a practical matter I was informed at almost the same time the public was about that.

Mr. ST GERMAIN. Do you feel as though it is sufficient just to be told what the problem banks are, or in view of the exposure, particularly concerning these last two cases of the FDIC fund; should the FDIC become more intimately involved sooner than they have in the past?

Chairman WILLE. Well, I think it is helpful that in any problem bank situation to identify the bank as early as possible, and all of the agencies are trying to develop early warning systems which will, in fact, alert them from published data and examination data with respect to a nonproblem bank that it is getting into some problems which may end up putting it on the problem bank list.

I would also have to say that this raises a question as to how we keep up our information with respect to national banks and State member banks which are examined by the other two agencies. There is a background to our own access to information, which I think should be before this subcommittee.

Back in 1950, there was an amendment proposed and later enacted to the FDI Act which would allow the corporation to examine national banks and State member banks for insurance purposes—the statute reads differently for those two categories of banks than it does for the nonmember bank category, which we are expected to examine routinely on a regular basis. The Conference Report that accompanied the 1950 amendment had this to say, and it is the background within which we operate in reviewing national bank and State member bank problems:

> In providing direct authority to the Corporation to make a special examination of any national bank, district bank, or State member bank, the conferees were firmly of the opinion that such authority is not to be utilized by the Corporation to embark upon a program of regular periodic examinations of such banks, which would only result in a needless duplication of effort. Such special examination authority is to be utilized by the Corporation only in a case where, in the judgment of the Board of Directors, after a review of the Federal Reserve or Comptroller of the Currency examination reports, there are indications that the bank may be a problem case or that it is in a condition likely to result in loss to the depositors or to the Corporation.

Well, we have seldom exercised the right directly to examine a national bank or State member bank under that 1950 provision in the light of the legislative history. We have in a number of cases received notice of problems for both State member banks and national banks at a time when corrective action may not be possible because it is already too late in the game, and your question is directed as well, not only to our own information, but how we could develop some of that information sooner, and I think that unless this subcommittee in a relevant report indicates its dissatisfaction with this 1950 Conference Report language and urges, instead, that on a sample basis, or something of that nature, we examine not only the problem banks that are national banks or State member banks but also, perhaps, the nonproblem banks, then the present system will continue.

Mr. ST GERMAIN. Could I interrupt you there?

It is not only the question of examination, it is a question of involvement. The Fed proceeded through the discount window to find $1.7 billion for Franklin National. This of course, as was brought out in earlier questions, had an impact upon the FDIC fund. In other words, subsequently, the collateral that was held for this $1.7 billion was not automatically turned over to FDIC but rather was used for other purposes. Part of it went to the purchaser.

We are saying it is important to have more accurate and more stringent supervision and regulation of these foreign branches by domestic banks because of their impact upon the stability and viability and strength of the parent institution here domestically, in relation to the FDIC fund. In addition to Franklin National, as I remember the USNB's loss was larger than all of the losses put together to date since the inception of FDIC.

So we are in a brandnew ballpark here, and it seems that the FDIC in its fiduciary capacity should come in a little sooner. And I should

like to add another point to that. In both cases the SEC was aware that problems existed with respect to FNB and USNB before indications from the bank regulatory agencies. Has the time come for more realistic and actual coordination amongst the regulatory agencies involved?

Chairman WILLE. Well, I think we are looking, you and I, at somewhat different problems. You are talking about the time when the Fed opens the discount window and should we not be involved at an early stage in that particular operation?

In both U.S. National and Franklin the Fed was lending at the window at the time the bank failed, and I would say that from the very beginning of the Federal Reserve's extension of credit to both banks, we were being kept informed on a regular basis. If it was not daily, it certainly was twice a week. We had up-to-date reports on the developments that were occurring in both banks.

I might say that today we have something which we did not have at that time. Those were two particularly big institutions to which the Fed was lending. But today we have through the good auspices of Chairman Burns and our own efforts to obtain the information, we have an understanding now by which we are informed regularly of all bank at the Federal Reserve window who are borrowing, not for seasonal purposes, but because of some unusual requirement.

So I would have to say in elaboration on your comments that in fact when a particular bank is identified as a problem and when it does go to the Federal Reserve window, we are kept informed. I do not want to indicate to you that we are kept in the dark until all of a sudden 5 months later or so the bank actually closes. That was not the case in Franklin and it was not the case in USNB.

Mr. ST GERMAIN. I realize that but I recall the situation when the Rhode Island congressional delegation was kept informed of the fact that the Navy was shutting down Quonset Point in Newport. They kept us very well informed and they took 14,500 naval personnel out.

Well, being informed is all well and good. But we could not do a blessed thing about it. I am talking about that other step where there should be consultation concerning what the future holds. Does the FDIC feel as though it is worthwhile for the Fed to keep pumping money or to keep that discount window open for this particular financial institution. Or should we immediately make an effort to determine if there is another institution into which we can merge this particular bank that has problems.

For instance, in Franklin National, it was the Comptroller who made the decision unilaterally that Franklin had failed and that time had come to find another institution within which to merge Franklin. Am I incorrect in that?

Chairman WILLE. Well, he did attempt to work out a merger without FDIC assistance, prior to July of last year. On July 2, he wrote us and said that his efforts had been unsuccessful, and would we please now enter the picture as an active participant in the negotiations for a resolution of the Franklin problem, which we did.

And the result was the resolution that was achieved 3 months later. Particularly with a large bank, these problems take time to work out and I do not want to minimize that in any given situation, particularly

if it has overseas impact, particularly if it is a complicated and messy bank situation, as both USNB and in some respects Franklin were.

The question that I see in this is the time when the FDIC has a role to play. And you are quite right in saying that when we are called in really depends upon the other two agencies with respect either to a national bank or a State member bank.

Mr. ST GERMAIN. I am not asking you to criticize anyone. I am just asking you, as Chairman of the FDIC, about the responsibility that you have sworn to uphold, to wit, to watch over the assets of this fund, to use it in the best way possible. Do you feel that it is sufficient to be kept informed or do you think that FDIC should not only be informed, but should be a participant in making judgments earlier than that point at which the Comptroller decides, whether it be Jim Smith or whomever? Should the FDIC be called in earlier before the efforts have failed? It is not a question of trying to create a controversy amongst the agencies, but rather to determine whether we are pursuing and following the best procedure possible. We should learn from what has happened in these two very large recent failures.

Chairman WILLE. I think that under the existing system, the situation that occurred in Franklin and USNB is quite likely to be repeated in the future, unless there is a change. I think in that respect you are quite right in pinpointing that particular aspect of the problem.

When I started to respond to your earlier question, I was actually considering at what earlier stage of the banks' deterioration could beneficial corrective action be taken.

I think by the time U.S. National was identified as a problem bank by the Comptroller, by the time Franklin Bank was known to everybody to be a problem, it was in many respects already too late to perform a rescue operation in the sense that you could correct the bank's situation and keep it going as an independent institution without a merger or some kind of an acquisition of some kind.

I think the uncertainty and the concern that we have at the FDIC is that the information we are getting is accurate information and full information, even before a bank is identified as a problem bank. And the earlier that there is an identification of a bank which is developing either earnings problems or asset problems, the greater likelihood there is of success and rehabilitation. And that would be the most meaningful thing that we could accomplish, I think, in order to contain the exposure to the Federal Deposit Insurance Fund. There is a point at which in these corrective programs, you are almost too late to try to rescue a given bank, except to make the best of a sorry situation.

And I think that we at the FDIC would all feel more comfortable if we were convinced of the adequacy and the accuracy of the information that we get, even with regard to our own banks.

I am not talking about nonproblem banks in the other agencies. But, even with respect to the reports of examination, which our own examiners prepare, it is one thing that you can never be quite sure of, until possibly things have gone wrong.

But at the present time, there is really no way of checking on that as far as the examination process is concerned for member banks or State or national banks.

Mr. ST GERMAIN. I want to turn this over to Mr. Patterson, but let me just ask this question.

The Fed advanced $1.7 billion on collateral to the Franklin National. The collateral consisted of loans that were due and owed to Franklin. During the period of time this window operation was operating, there were repayments. In fact, some of these loans were repaid in full. Do you know whether or not Franklin had this money available to lend out once again to prime borrowers at high rates, or were these funds inaccessible to Franklin at that point?

Chairman WILLE. No; I do not believe that Franklin was receiving funds at the discount window which it was in turn lending out in any significant quantity.

Mr. ST GERMAIN. I am talking about the repayment to Franklin by borrowers of funds. In other words, the Fed held collateral for the $1.7 billion, I think you said about $2 billion with collateral this morning.

On that collateral an interest was being paid. And in some instances, not only was principle being paid, but in some instances, the entire amount of the loan was paid off.

Now, do you know whether or not those funds were then made available to Franklin to lend out again to borrowers when they were attempting to keep the operation going?

Chairman WILLE. I would have to answer that, I think, for the record, after a more deliberate search of the facts. I am not completely familiar with the way in which the discount window mechanism operates.

But I am quite sure that the net effect of any such repayment was not to give Franklin more funds to lend to new borrowers. It may have been useful, as far as meeting preexisting commitments were concerned. But since Franklin was in the situation where each day it was borrowing more and more money with some fluctuations, day by day, from the Federal Reserve window, I think it very unlikely that they had any net inflow to lend during this period of time.

Mr. ST GERMAIN. Well. we would appreciate that for the record, because there are those who have intimated such and we should have it accurately answered for the record.

[The information referred to contained in FDIC's response to subcommittee dated September 3, 1975, may be found in appendix A.]

Mr. ST GERMAIN. Mr. Patterson.

Mr. PATTERSON. Thank you, Mr. Chairman.

Chairman Wille, at the outset I want to say that both your comments oral and written are very informative to me as a new member of this subcommittee. And I appreciate it and thank you very much for that.

I would like to comment and ask some questions regarding your regulatory reform, perhaps taking a devil's advocate role. I have read your testimony and really felt that your stronger arguments were on the side of the single agency.

The only thing that worried me a little bit, I think, was on page 2, where you gave arguments in favor of a single all-powerful Federal bank regulatory agency. I think when I got to that point, I concluded you were not in favor of it. Since you said all powerful, it kind of bothered me just a little bit.

Chairman WILLE. Well. I think it fair to say that when our staff was looking at a single Federal banking agency, what they were commis-

sioned to look at was one that would consolidate all of the powers of the Comptroller, the Fed in bank supervision, and the FDIC. There are different kinds of consolidation as I mentioned to Mr. St Germain. And I would not say that all of these arguments pro and con would necessarily be applicable in the case of some intermediate type of consolidation.

In fact, Director LeMaistre and I hope we can come up with some proposal which would be a meaningful, greater centralization than we have today and still retain what we think are the benefits of the present system, of which I think there are quite a number.

Mr. PATTERSON. Do you think this type of recommendation would be forthcoming to the Congress?

Chairman WILLE. We certainly are going to be working on it very hard during the course of the next few months. It is not an easy area. And it has ramifications well beyond just the matters of bank examination and supervision that we are talking about. It can have an impact upon monetary policy if we do it improperly. It can have impact in other areas, which I am sure neither this subcommittee nor the FDIC would want to occur.

And that is one reason why I am not giving you something specific today, by way of a detailed proposal. However, we have done enough work, I think, to believe that a proposal of this kind, in the intermediate range, between no consolidation and total consolidation is possible, preserving the benefits of the present system.

And we will deliver that to the subcommittee as soon as we develop it.

Mr. PATTERSON. Do you think that some type of consolidation could have perhaps prevented the U.S. National or the Franklin's failures?

Chairman WILLE. No; I do not really think so. On that, I am quite confident of my response.

Any major bank failure is probably a function of two things: One would be mismanagement at the bank, of some kind, and one would be a failure of supervision. Obviously, one may be more important than the other. I think that in most cases the bank's mismanagement is the more important of the two. And yet, obviously, certain types of regulatory steps might have been taken which could have resulted in different outcomes in both cases, had they been taken earlier.

Now, the question is: Would those kinds of corrective steps have been taken early enough, if we had had a different kind of bank regulatory structure in the country? I must confess that I cannot answer that "Yes".

It seems to me that those of us who are in positions of responsibility running the bank supervisory agencies must in large part depend upon the factfinding that we get out of reports of examination. And you can have deficient reports of examination, whether or not you have got a single Federal bank agency.

And it can occur today in the Comptroller's office, it has occurred in our office, and it can occur at the Federal Reserve. While we must rely on reports of examination to do an adequate job, there are times when such reports are not adequate, for whatever reason it was; that is, the training of examiners, or the approach that they take to a particular bank's problems, or their perceptions in the case.

So I think your question really raises the human equation. Mistakes can be made in any organization, whether it is a consolidated agency or three separate ones.

Mr. PATTERSON. The main advantages in keeping the present system, I think you cited, are flexibility and diversity. It seems to me that the counter to that might be that it creates a certain amount of confusion, a lack of certainty, a lack of uniformity, predictability, in terms of not being able to predict one agency, vis-a-vis another in equality in treatment. A bank may fall under, two but not all three agencies, another bank under one out of the three and this sort of thing.

Chairman WILLE. There is no doubt that what you say is true and that you have to weigh out these different elements and come to some sort of a conclusion as to which direction you are going to head in.

As I had hoped this paper would make clear, Director LeMaistre and myself both believe that there are some significant advantages to a greater degree of centralization than we have today. We do not want to lose what we think are the benefits of flexibility and innovation which come from the present system. And we will be at work seeing if we can marry the two concepts.

Mr. PATTERSON. What do other countries, for example, have in the way of regulatory agencies? Are they comparable to ours?

Chairman WILLE. I do not think that there is any country in the world with a system like ours.

And I would just elaborate by saying I do not think there is any country in the world that has 14,500 banks.

Mr. PATTERSON. Would most of them have one regulatory agency?

Chairman WILLE. That is my understanding, that most countries have a far fewer number of banks and they are more centrally regulated by one agency at the national level.

Mr. PATTERSON. In your legislative proposals, you made some suggestions which I assume were also made by the Comptroller and others. Would it not be easier if you had broader jurisdiction or if some single agency had broader jurisdiction to decide what is your perimeter and wherein you should make legislative proposals and suggestions for legislative change?

Do you not have to, under the present system, stay within your own bounds and not go beyond whatever your particular jurisdiction might be? And yet you might be able to see something, that legislative change in an area that is not under your institution could assist.

Chairman WILLE. Well, I think alone among the three existing agencies, the FDIC probably has a greater overview of the whole system because of the insurance function. We do insure deposits at national banks and State member banks. Actually, the six recommendations that we submitted grew out of our analysis of the failure of the U.S. National Bank in San Diego. We have had other failures over the years, both of State member banks and nonmember banks, which we have examined, and, in our view, the suggestions that we are making are the composite result of all of those experiences, so I do not think we have been inhibited by the fact that the FDIC has not had jurisdiction over national banks or State member banks. I cannot speak for the Governor of the Fed or the Comptroller.

Mr. PATTERSON. When there is a bank failure such as U.S. National, what role do each of the three agencies play in terms of deciding who is going to come in and take that receivership or what bank might be the one in line to purchase or acquire the fallen bank?

Chairman WILLE. Well, in some cases the purchase can be accomplished without any Government input of money or guarantees against loss that is, the normal bank-to-bank acquisition. Banks make offers every day of the week for mergers with other banks, and this approach is attempted in all of these cases. U.S. National was seeking a merger with another bank without any FDIC or Federal Reserve participation. Similarly as to the Franklin National and Security—the Comptroller was successful in arranging, at least for Security National, a bank-to-bank merger last January without any Government assistance, and it probably prevented the failure of the Security National Bank of Long Island.

As the immediate regulator of national banks, the Comptroller feels quite properly that he has the first responsibility for trying to accomplish that result. The Comptroller does not have a kitty of cash or the powers that FDIC has by which Government assistance can be thrown into a national bank merger, and, therefore, if a national bank problem is not susceptible to a solution by a bank-to-bank merger because the other bank that is buying thinks there is just too much risk involved, whether it is in earnings or an asset risk or whatever kind of risk it might be, so that they do not want to take it without special protection, when that is the Comptroller says, I cannot do it with my own supervisory powers or my own powers of persuasion. We need the support of the Fed, if it is a liquidity problem, at the discount window or we need the support of the FDIC for a possible receivership and a sale out of a receivership, if it comes down to a receivership, and your question is to me, how do we go about deciding who buys.

We have made a very conscious effort at the FDIC to make sure that we have more than one potential buyer, and this can be the cause of significant delays, as it was in Franklin. We have determined that there is no fairer way of setting a price on a given deal than to get competitive bidding on a uniform basis.

We have seen time and time again that this brings the best price for the shareholders and the debenture holders, the residual claimants of the bank that is going down. It is also the one that best protects the FDIC fund, so we are convinced proponents of competitive bidding in this kind of a situation.

Now, we are limited by State law. New York did not permit out-of-State bank holding companies to come in and acquire the Franklin. We had to find our purchaser, if we could, within New York State for Franklin, and we systematically went about consulting 20 of the largest banking organizations that we felt could handle this kind of an acquisition. Franklin was then a $4 billion bank, and there are not that many banks larger in size in New York, six or seven, perhaps. In addition, there are multibank holding companies. We consulted them as well. They had banks in different parts of the State that may have been smaller than Franklin. We did this in as thorough a way as we possibly could. We sometimes get potential acquiring banks in the room together and explain it all to them at one time.

We did not do that in Franklin because I felt that the problems were so severe. I, at that point, was negotiating for the Government and determining our negotiating tactics and strategy, but it seemed very obvious to me that banks would be more candid with the FDIC if they were to be talked to separately with regard to the possibility of acquiring Franklin out of a receivership.

We went through 20 different discussions and consultations early in July, right after the Comptroller notified us that we had to get into the picture. Only 4 banks out of the 20 survived as seriously interested bidders for the Franklin situation, and it took us a considerable period of time to work out a transaction on which they would bid on a uniform basis. We might have had an earlier resolution had we been willing to go with one bank in a negotiated transaction, no competitive bidding. That particular bank would have resulted in the most anti-competitive solution. It would also probably have resulted in a far lower price for the total transaction. We deliberately chose not to go that route because we did not think it was fair, and we thought that there was time within which to develop a competitive bidding proposal where all four banks might be willing to bid. We did that. The same terms were offered to everybody, and the only thing we did after the bank was declared insolvent and closed at 3 o'clock on October 8 was to ask each of the four banks which were still in the running, so-to-speak, what price each was willing to pay for the whole transaction. All four of them submitted bids and they ranged over a wide spectrum of dollars. The high bid was $125 million; it was submitted by European-American, and they were declared the purchasers of the Franklin.

It could easily have been the Chemical or the Manufacturers Hanover that was the winning bidder. We had no inkling of what their sealed bids would contain at the time we opened them. We had some reason to believe we would have at least two, both of which might be over the minimum bid that FDIC felt we had to have in order to work out this kind of a transaction under our statute, and that is how we selected the European-American in the case of Franklin.

Now, we had been negotiating with the European-American and the other three bidders for 6 or 8 weeks, and while there may have been some chagrin that a European consortium would win the competitive bidding procedure in the Franklin situation, we could not possibly, at that point after having negotiated in good faith with them for 6 or 8 weeks, declare them for some reason unqualified or ineligible, and no serious thought at any time was given to that possibility.

The European-American is owned by six major banks in Europe, with total assets of $92 billion or more. We felt, even though their New York subsidiary was a relatively small one, that it could immediately recapitalize and that it could call upon the necessary management, both within the United States and from abroad, which would be able to take over 103 offices of the Franklin, and the State Banking Department in New York confirmed the judgment that they were capable of taking over the Franklin, and we had no hesitation when the bids were actually opened in awarding them the bid as the high bidder.

Now, in the U.S. National Bank situation in San Diego we went through the same process of consulting those banks in the State of California that we thought had the management capability and the

financial capability of acquiring the 60-some-odd offices of the U.S. National. We ended up with only two conforming bids in California. Fortunately, both of them were bids that we could have accepted, had we had to, and we obviously accepted the higher bid. At that point, when we accept the high bid, we are actually receiver of a closed bank, and, as receiver, we have an obligation to subordinated creditors and to shareholders to get the best price we can. It is a fiduciary responsibility under general principles of fiduciary law, and we have felt throughout our failed bank experience that competitive bidding was the best way to assure the fairest price.

Banks have different reasons for bidding, and they have different values they place on the acquisition in question, and that is proved time and time again in our experience. Since we have done it in those two large cases, I think I might also add that we routinely attempt to work out the same kind of purchase and assumption out of a receivership for any bank that fails regardless of size. We have had small banks of $3.5 million, or $10 million, or $20 million, or $75 million that have failed, in which we go about the situation in almost exactly the same way. The difference is that when you have a bank that is $2 million, $5 million and so on and so forth, up to, say, $100 million or $200 million or so, the FDIC can advance cash on the asset side of the transaction at the same time we ask a bank to take over all the deposit liabilities. We say, do not worry about the assets; we will work them out in liquidation over several years or so, if we have to, and we will provide you instead with cash. But when you get a billion dollar bank or a $2 billion bank, and we have a $6 billion fund, we do not offer cash quite that readily to balance off the deposit liabilities. In such cases we try to work out a transaction with a minimum cash outlay from the FDIC and that is what we did in Franklin and U.S. National. That was one of the reasons for the delay in resolving both cases. We used as many of the assets of the failed bank as we could in order to make up the assets on one side that the acquiring bank needed to balance the deposits they were willing to assume on the other, and we were successful in both of these cases, as you know, with minimum FDIC outlays.

Mr. PATTERSON. Well, thank you for a very informative answer. Just a couple more questions along those lines. How do you insure that there is, in fact, competitive bidding? Do you go through any process to make sure that such bidding that does take place, rather than any group or groups to getting together to decide whose turn it is? How do you approach that kind of a problem?

Chairman WILLE. Do you mean how do you prevent an antitrust violation where you have group bidding?

Mr. PATTERSON. I think this would be much more difficult with a larger bank where you have few bidders anyway, so I would assume where you had two other potential bidders that there are going to be enough ready to bid, if there are only 4 or 5 or 10. My question is asked of you because I do not know how do you do it. When you have a minimum bid, does that relate to the minimum bid that you, I would assume, require—maybe, I had better ask that question first. Do you require a minimum bid before anyone can acquire or not?

Chairman WILLE. The minimum bid to which I referred in my earlier answer is a reflection of our statute which says we do, basically, one of two things when a bank fails. We either pay off deposits up to $40,000, or we try to arrange one of these acquisitions where all the deposits are taken over 100 cents on the dollar. Our statute says that we can do the latter based on an assessment by our board of directors that is likely to result in least cost to the corporation, which means least cost to our trust fund. It is not an item of administrative discretion, although we have a lot of flexibility in how we determine which procedure is likely to result in least cost to the corporation, and we do use that discretion.

In the cases of U.S. National and Franklin, none of the banks that were interested were informed as to what we felt internally we needed as a minimum bid before we would accept any bid that was offered. Fortunately, in all of these cases, the actual bids that came in were well over what we considered to be a minimum that we would have to have.

Mr. PATTERSON. Wouldn't that always be the case, since your minimum bid based upon your insurance risk would certainly be much less than the value of the assets the bank would be acquiring?

Chairman WILLIE. It does not always work out that way, curiously, and it goes to the question of the value which someone for business reasons would place on the transaction. Acquiring banks would necessarily be looking at it from a business opportunity point of view, and I cannot make that judgment for any bank. For example, we have had the most difficulty, I think, in arranging acquisitions in the case of failures in unit banking States. One of them is Texas and the other is Illinois, and we have found that where you have only one office banking, that the groups to which you would normally go trying to find a purchaser may not be as numerous when the chips are down. We have had a number of failures where we pay out the $40,000 in both Texas and Illinois where, because of location of that one office of the bank that failed, or for some other reason, there were no bidders, even though we tried to generate some bidding interest. In that case, of course, we have no choice. We pay out the insurance limit.

All I can say at this point is that we try to arrange a takeover where no depositor gets hurt. We cannot always do it. We seem to have the least amount of success in unit banking States like Illinois and Texas. In the case of these large banks, how do you make sure that these banks do not get together on bidding? It just has not been our experience that that has been a significant problem. Some banks may walk away from a proposed transaction, but they do it for legitimate reasons. Either they do not have the capital or the management to take it over, and the way the bids have come in, it would indicate that there obviously is no collusion. In Franklin, each one of the groups that we were talking with seriously throughout August and September actually did bid, and the prices they put on the transaction were all different. Each one of them was advised, of course, by counsel as to the antitrust implications of getting together on a bid. It just does not happen.

Mr. PATTERSON. Do you make the same exact information available? I assume you have a packet or specifications, or whatever, specifying

what the conditions might be, and what if a bank wants additional information? Can you supply that to only the requesting bank or do copies of such go to all of the banks that are interested, or do you not supply any such additional information?

Chairman WILLE. Well, in the case of an all-cash transaction such as I described for the smaller banks that might fail, requests for that kind of information are not very numerous because all of the bum assets of the failed bank are taken over by FDIC and liquidated, so they do not care. They are getting cash, and what they are interested in are the deposit maturities and the rate of interest on those deposits they have to pay. That we give to everybody, so a cash deal in a smaller bank is quite routine, is uniform, and we have very little request for additional information.

This was not the case in U.S. National or Franklin. We had specific requests for detailed additional information. We were trying to find the formula by which a maximum of Franklin assets could be taken over, rather than FDIC cash. We found that formula, but every bit of information we supplied to any one bank was given to all the interested banks so that no one had an advantage as far as basic information was concerned.

Mr. PATTERSON. My final question is in regard to the selection of buyers. Is there a selection of those banks that are eligible to submit a proposal, or if that is not the right way to ask the question. Do you, in your review, screen out some banks? What things are you looking for in terms of screening out any that might want to purchase but not be chosen?

Chairman WILLE. Well, you are quite correct in thinking that in a realistic sense there has to be some preselection. Who do we talk to? In the first place, even before we find out whether they are interested in a particular acquisition, we do our best to spread that net as broadly as possible. In the case of the most recent small bank, relatively small bank failure in Illinois, the State Bank of Clearing which failed about 10 days ago, we consulted 12 different groups. Now, Illinois has no multibank holding companies, so these were groups of people that were interested in chain banking, that we knew had formed new banks, and were active in the Illinois market. We had gone over such a list rather systematically in advance, knowing that we might be called upon to do this.

A list of those groups financially active in banking in Illinois was developed: We might have eliminated some because of supervisory experience in given banks that they did run. I do not say that we do not do that. We try to find a bank, particularly in a unit banking State, that can put in the management quickly for a newly formed bank that would have to be formed to take over the deposits of the failed bank, and if we are not satisfied with the management they have had in other banks, we do not even talk to them. But even after that process was finished we had 12 groups that we were willing to talk to on a competitive bid-type basis, and we ended up getting only 2 bids out of 12. Fortunately, we had one that we felt we could accept.

In the case of the Franklin and the U.S. National, you start with a fairly big problem and you have got to find a fairly big solution in the sense of a big bank or a bank able to call upon substantial

additional resources, either of money or of management. In the New York case, that led us to the 20 banks that we were talking about, some of which had assets of only $500 million or so, which was one-eighth of the total size of Franklin. European-American was in that category, but it was a special bank, and we talked to a good many other New York subsidiaries of foreign banks as well, all of which could call on money from overseas on short notice to help in a solution of this problem. As I say, only four banks ended up being seriously interested despite the preselection of who we talked to.

Now, we cannot under most circumstances advertise that on a certain day, *x* bank is going to fail, and we should like to have people ready to put in bids on a uniform basis. We just cannot do that, and, in fact, even in the negotiations, both in San Diego and in New York, the actual date when the Comptroller might move was probably the most carefully preserved secret in both negotiations, and was only determined by him after he felt all of the preparatory steps had been taken. So, even there, we were doing our best to maintain some cloak of secrecy over our actual negotiations and discussions in order not to have even more traumatic impact upon public confidence in banks in those two States.

Mr. PATTERSON. Thank you, Chairman Wille. Thank you, Mr. Chairman.

Mr. ST GERMAIN. Chairman Wille, in November 1974, you reported to the Congress on Franklin, and you discussed the problems related to the assumption of Franklin's foreign exchange contracts. In that report you stated that the use of the FDIC's fund to work out the possible loss in the foreign bank's foreign exchange position would come as a great surprise to many. You state, however, that you agreed with the Fed that it was imperative for stability in the foreign exchange markets that Franklin National Bank's unexecuted foreign exchange contracts be honored since the FDIC could not assume responsibility for honoring those contracts. The responsibility was left to the Fed which then began to execute the contracts in September. Although the Fed requested and received the deposits of Franklin to cover any losses, it was fortunate in being able to make such an arrangement before the bank went into receivership. Despite the deposit, the clear implication with relation to the insurance funds absorption of foreign funds losses for an insured bank is that it is all right for the taxpayer to absorb losses through the Fed. I would appreciate your comments on this, because it seems very likely that should another large bank go into receivership, the question of how to deal with the foreign exchange contracts will come up again. This is a little different from the deposits we were talking about earlier.

Chairman WILLE. Well, the Fed of New York and the Fed in Washington were farily conscious of the problem to which you refer, which is that if they guessed wrong on the exposure in these foreign exchange contracts which were open and were unexecuted last September, that in fact could have a significant impact upon their own operations and the possible return of surplus revenues to the Treasury for the benefit of the general taxpayer. For this reason, although they had a very expert foreign trading desk in their New York bank, they also obtained the advisory opinions of each of the four banks with which

we were seriously negotiating as to the risks that were involved in the open Franklin foreign exchange book. The Fed determined after that review, and I think on a very conservative estimate, that with a deposit of a certain size—and I think it was roughly $15 million, or something slightly less—they would be able to work out the Franklin's unexecuted foreign exchange position without loss to themselves, and I think they were reasonably satisfied on that score. In fact, there was an immediate refund of $5 million or so of that original deposit which they attributed to confirmation risks, that is the risk that parties to certain contracts with Franklin would not be willing to execute them with the Federal Reserve Bank of New York. In fact, virtually all of the other parties on the foreign exchange contracts with Franklin, once they found that the Fed of New York was willing to execute them, were only too delighted to confirm with the Fed and that particular $5 million was returned promptly.

Well, in this case the bank closed before the money was returned, and so it came to the FDIC in Franklin's place. The remaining $10 million was designed to cover the risks of execution in these contracts. The Fed of New York had to cover these contracts, to hedge transactions, and the like. They set about doing that very promptly and, in fact, even if we do not receive the $6.7 million net return on the remaining deposit which we are hoping to get, as I have indicated on page 4 of my status report, all of the open Franklin contracts will have been fully executed by the Federal Reserve of New York and there will still remain something like $25,000 to $50,000 of the original deposit, so their estimates were very good and very conservatively done.

Mr. ST GERMAIN. That is all well and good in this particular case, Mr. Chairman but supposing this should come up again?

Chairman WILLE. In the event that it comes up again, I suspect that we will move rather promptly toward the kind of solution that we had in Franklin and do it at an earlier stage. This foreign exchange book of Franklin was a continuing problem in the negotiations until the very last 2 weeks, and it was a solution that did not readily present itself until the end of September. Now that that pattern has been established, I think we will reach it much more quickly in any future situation which, hopefully, will not occur. We also have been giving some consideration at the FDIC to whether or not we should seek some sort of specific legislative authorization for the FDIC to deal in these foreign exchange positions of banks that possibly end up in receivership. That is another complicated area, and we have not made that suggestion in our technical amendments bill to you. We will continue to have that matter under discussion.

Mr. ST. GERMAIN. Do not get me wrong when I say this, but just keep in mind what is that expression, fools rush in where angels fear to tread. I am not saying there is anything foolish about the FDIC.

Chairman WILLE. Well, we are going to be very careful about it.

Mr. ST GERMAIN. Between 1950 and 1962, Franklin's assets increased dramatically from $50 million to $1 billion; earnings were 15 and 20 percent of stockholders' equity, and, yet, management was unsophisticated and incompetent, we are told. Certainly, we are all interested in maintaining a stable banking system. How extensive a role should

the regulatory agencies play with respect to the competence of bank's management? But, then I would also like to add the question of the role of the agencies in involving themselves more readily when they ascertain that a condition exists such as existed in USNB when you had a question related to competence. I guess we have to all admit C. Arnholdt Smith was a particularly competent man. The only problem was he was a very domineering man, and his competence was directed more toward his own benefit than that of the shareholders of the institution.

Chairman WILLE. Well, there is no question that the bank agencies, all of them, attempt to evaluate the quality of management and its performance in their regular reports of examination. This is a routine item that results in a confidential rating of the bank's management which is given to the examiners' superiors, not usually to the board of directors of the bank.

In the event that any one of the three agencies felt a need to change the management of a given institution because it was leading the bank into an unsafe and an unsound condition, it is the belief of the FDIC and of our legal division that, in fact, it would be an appropriate use of the cease-and-desist power which is now in our law and has been there since 1966, not only to correct a given condition of the bank, but also to require a part of a corrective program that the management of the bank be acceptable to the supervisory authorities.

Mr. ST GERMAIN. As far as competence is concerned?

Chairman WILLE. As far as the policies of that management are concerned; we are talking about the policymaking level of the bank's management.

Mr. ST GERMAIN. But, if there is incompetence, then certainly wouldn't it follow that the policies would not be that which we are looking for? I am just wondering if you do, in fact, have sufficient authority under the cease-and-desist powers. You know in Northern Ohio—and that is the last case we are going to discuss a little while later on—well, in that instance, you employed the means initially of denying insurance, FDIC insurance coverage, correct?

Chairman WILLE. Yes.

Mr. ST GERMAIN. Let us look at Northern Ohio just a moment. We will get back to it later. Let us say that they had their insurance and they brought in Mr. Palmer to manage the bank, and after 6 months you became dissatisfied with the way he was running things and you looked into his background. Could you have employed your cease-and-desist powers as you presently have them to ask that Mr. Palmer be removed?

Chairman WILLE. We believe that it is possible to so use the cease-and-desist power on an appropriate showing which is reflected in the condition of the bank.

Mr. ST GERMAIN. We are laying groundwork, Chairman Wille, for the future and for the FINE study and for reform.

Chairman WILLE. I understand what you are saying. When you serve the cease-and-desist on a bank and you cite all of the unsafe or unsound conditions which may be present in that bank, and, as part of the corrective program, seek a change, particularly in the chief executive officer of the bank, the bank itself has the right to contest that cease-and-desist order and, depending upon the board of direc-

tors' own evaluation of that chief executive officer, might well be tempted to do so. The cease-and-desist orders that we serve are not necessarily final unless there is a consent to them in short order. If they are contested, then they may go on for some time while the bank exhausts its remedies.

So, to make a cease-and-desist order effective where you are seeking a change in the chief executive officers of the bank, you almost have to have, in order to be able to do it quickly, the agreement of the bank's board of directors. In many cases, you will not get that, either because the chief executive officer, himself, has selected those directors; or he is under their control; or he is a control shareholder. There may be lots of reasons why the board of directors may be unresponsive to a regulatory request or demand to change the CEO of a bank.

If you are in that situation, you then look at the removal provisions which we have for bank officers and directors, and they are limited. As you know, there was quite a battle in Congress some years back as to what authority to give the bank agencies if they felt, for a variety of reasons, usually quite serious, that a bank officer or director should be removed, and at that time the eventual outcome was that bank officers and directors had to be shown guilty of a violation of law or some proper order or so forth, which would be the threshold question. Let us assume you got over that, you still could not remove the bank officer responsible unless, first of all, he was guilty of personal dishonesty and, second, that he had caused or is likely to cause substantial financial loss to the bank. Usually, the loss to the bank is not so difficult to prove. There is also statutory language, about his actions being prejudicial to the interest of the depositors. Well, one of those two standards is usually easy to satisfy when you have a problem bank which is going downhill very fast.

The tough standard is personal dishonesty. You have got a lot of mediocre talent in some of our problem banks, obviously. In many cases you have officers who are grossly negligent and, yet, are not guilty of personal dishonesty. They have not put their hand in the till or taken out the dollars that might result in that finding. We have made a recommendation in our legislative proposals for a new standard in addition to the personal dishonesty standard, which would allow a bank officer or a director or a controlling shareholder participating in the affairs of the bank to be removed from that participation if you can show a willful disregard for the safety and soundness of the bank, and we believe that to be a desirable additional standard. It is one that I doubt the agencies will use in any arbitrary or capricious way, but which, in some circumstances, would be very helpful where we cannot act today to change the policy management of the bank.

Mr. ST GERMAIN. In regard to what you said earlier in your response concerning boards of directors, do you not feel that in concert with this legislation, or this type of recommendation, that the liabilities, as far as members of a board of directors are concerned, should be spelled out a little more forcefully? It is my information to date, and I think you and I have discussed this before, that historically in all of these bank failures, even though it was patently evident that the members of a board of directors were very negligent in performing their duties, nonetheless it is just about unheard of that any of them

have been found liable to the stockholders of the various financial institutions for their actions or for their inactions.

Chairman WILLE. Well, if we end up being the receiver of a bank that is closed, we investigate the possibility of a claim against the directors. Usually that is a bonding claim, since they are bonded against certain types of action, and we reach a fair number of settlements with bonding companies short of litigation. In some cases we feel that the bonding company liability is much too low for the particular offenses of the directors as, indeed, we believe is likely to be the case, say, in U.S. National. All right, we will pursue a personal liability claim against the directors in situations like that. Our problem is not bringing suits or trying to get them settled on a reasonable dollars-and-cents basis. For the receivership our problems come if there is a total refusal to compromise or to offer a middle settlement. We find that jury convictions for violation of a director's fiduciary duty are sometimes very hard to come by, and many directors, unfortunately, pursue that possibility to the fullest extent. To the extent that this subcommittee might be minded to increase the direct liability of bank directors, I think that could be a significant help in problem bank cases to the bank agencies.

Mr. ST GERMAIN. Well, I think in view of some of our recent bank failures and the problem banks, even many of those that have merged, that there is a strong indication that there has been a great deal of negligence on the part of the directors of many of these financial institutions. They just have not exercised their responsibilities properly. Perhaps we could get the Congress to do something if we were to have a study that would indicate this, and maybe our staffs could work with your staff to get to this.

Chairman WILLE. I would certainly not be prepared to dispute that comment. I think that in a problem bank situation or failed bank situation quite normally there is gross negligence on the part of a board of directors, and, in fact, their own responsibilities should be brought home to them in a very direct way, which sometimes is not the case when you have to rely on litigation in the courts to impose that.

Mr. ST GERMAIN. Or in negotiations?

Chairman WILLE. That is right.

Mr. ST GERMAIN. I just read last week where C. Arnholdt Smith—and I want to correct the record now—I think his fine was $30,000. I think that is the accurate figure. And I read last week where the repayment is at the rate of $100 per month, because he has come upon hard times. Is it accurate to assume that much of this is due to the fact that a great portion his assets have been tied up with attachments by FDIC, or did he plan for the future and divert some of those assets to areas where they cannot be reached?

Chairman WILLE. My chief liquidator, who is right here, and I would have to say we wish we knew. The Internal Revenue Service, I believe, has attached all his assets that it could find. In any event, his remaining assets do not go, by any manner or means, to the full extent of our claims against Mr. Smith.

Mr. ST GERMAIN. Do you have any figure for the subcommittee as to the amount of assets that you have been able to attach?

Mr. HILL. We at this point have not attached anything.

Mr. ST GERMAIN. Any liens? I mean, we are not being technical with terminology here.

Chairman WILLE. We have sued like mad, Mr. Chairman, to the extent of $100 million or more. The problem is, we have been unable to find many assets in C. Arnholdt Smith's name that have not been attached by the IRS.

Mr. ST GERMAIN. Well, once again, I will repeat; you cannot accuse him of incompetence and unsophistication.

Chairman WILLE. General counsel informs me that IRS attaches virtually everything they can find, and that its claim has priority over any of the receiver's claims.

Mr. ST GERMAIN. Chairman Wille, with respect to the line of questioning by Mr. Patterson, you discussed the larger banks in New York. Was there any consideration given to a group of small banks taking over or dividing up Franklin?

Chairman WILLE. Yes, Mr. Chairman. I am glad to be able to correct Governor Holland's testimony last week on that. We recognized that, were we able to develop a consortium of New York banks that possibly were smaller in size, in the same way that European-American was a consortium of large European banks, we might be able to develop additional bidding groups for the Franklin assets and deposits we were attempting to transfer. And for that reason, we went to the Department of Justice, and talked with them about the legality and the propriety of having small individual banks in New York consult among themselves with the point in mind of forming a consortium to bid jointly for the same proposal that we were developing for the four larger bidders.

The Department of Justice indicated to us that they would have no objection to such banks having those discussions, or joining together for the purpose of joint bids, so long as no more than one of the five largest retail banks in the New York metropolitan area were in any one group—in other words, Chase and Citibank, for example, could not have been in the same consortium. In fact, some of the banks with which we had discussed the matter—that is, the group of 20—had indicated to us that they were prepared to go part of the way, but they could not see their way clear to go taking over all of the Franklin, and we wanted to see whether or not we could encourage two or three banks, all of whom had responded that way, to join together and see if they could allocate assets and offices, and attempt to work out a subsequent separation of the assets and deposits they might have gotten from Franklin.

In fact, even though we had this Department of Justice clearance, and gave it to all of the banks with which we had talked so that they knew this was a possibility and could go to any of the commercial banks in New York, large or small, whether we had talked to them or not, and involve them in a group or consortium effort for a joint bid, none of these efforts came to a successful conclusion.

Some banks that looked at the possibility of joint action told us that it did not seem to be feasible to work out the arrangement internally among the members of the group, much less putting a dollar value on the bid they would jointly submit for Franklin. In any event, nothing came of that. But we did try.

Mr. ST GERMAIN. And so you feel that it was more the proposition, rather than any inhibitions or prohibitions, that was responsible for

the fact that they were not able to get together a group of the smaller banks to take over Franklin?

Chairman WILLE. That, and the necessity of having to work out among themselves their own relationships with regard to this huge problem.

Mr. ST GERMAIN. In other words, it was more contractual problems among themselves than any restrictions placed upon this type of consortium by legislation or regulation?

Chairman WILLE. That is correct.

Mr. ST GERMAIN. Let us turn to Northern Ohio Bank for just a moment. The recent published article in the press stated that there were inconsistencies in the handling of Northern Ohio's problems by the FDIC. Would you care to comment for the record on these alleged inconsistencies?

Chairman WILLE, I have read the article, which appeared last Friday in the Wall Street Journal. I believe that some of the actions the FDIC took with regard to Northern Ohio Bank may appear to be inconsistent to outsiders. We think that, based on our reports of examination, most of the actions we took were justified. On the other hand, I would be the first to disclaim any satisfaction with the way in which FDIC handled the Northern Ohio Bank situation from its inception to its closing 4 years later.

We are in the process of reviewing the various actions which the FDIC took in connection with the initial insurance, and the subsequent examination and supervision at that bank. I would be glad to elaborate this answer for the record at a later date.

Mr. ST GERMAIN. We would appreciate it. As I stated earlier, Mr. Palmer originally was the cause for FDIC's not finding Northern Ohio eligible for insurance, and so it was withheld. Evidently, there must have been something in his background that occasioned this withholding of the insurance, and the question now is, Why was no objection made to his reinstatement as chief executive subsequently? You might want to answer that for the record and outline for the subcommittee what Mr. Palmer did to change his image, as far as the FDIC was concerned.

Chairman WILLE. I shall.

[The FDIC's response to the subcommittee dated September 3, 1975, may be found in appendix A.]

Mr. ST GERMAIN. Was FDIC aware of the alleged business dealings of Mr. Alex Dandy in connection with Northern Ohio Bank? In other words, did it appear in any of the examiners' reports that, as contended in the article, he obtained substantial finders' fees?

Chairman WILLE. I am informed that that relationship did appear in some of the reports for examination of the Northern Ohio Bank.

Mr. ST GERMAIN. You are familiar with the type of information this subcommittee ordinarily looks for, and likes to have, as a result of our work with you on prior failures. So, in order to expedite this, if you would give us some of the excerpts from the examiners' reports on this, we would be most grateful. And once again, this is the type of information which we just keep accumulating and hopefully collating for the overall study that we are going through.

Since European banks, as we know, are not subject to the same restrictions as are placed on our domestic banks, as far as reserve requirements, investment banking interests, and interstate activities

are concerned, what consideration in accepting European-American Bank's bid for Franklin was given to the possible competitive advantages that the parent banks of European-American were granted by such a transaction?

Chairman WILLE. Well, to the extent that we knew that foreign banks in this country could conduct business that was broader than that available to American banks—that would be true not only of European-American, but it would be true of any foreign-owned bank, of which there are several in New York, and with whom we had spoken in connection with developing their interests in the Franklin situation.

The reserve requirement aspect of that question is a little tricky. Domestic banks themselves are not necessarily required to maintain reserves, unless they are members of the Federal Reserve System or are required to do so by State law in the event they are nonmembers. In that respect, foreign banks are no different from American banks today. It is true that they may have investment banking arms, and in fact there are certain aspects of competitive business which the European-American complex of banks can perform in New York through something called an investment company, or investment corporation.

The powers of an investment company under the New York banking law are a little bit different than those of a securities broker or dealer, as the term is normally expressed. I think that problem was recognized, to the extent that we solicited the interest of European-American, and continued to negotiate with them during the course of the summer last year.

Mr. ST GERMAIN. As a direct followup to that question, Chairman Wille, there are some people on Long Island who contend that their financial needs are not being met. Evidently, Franklin National was heavily involved in the financial affairs of Long Island, not only on a personal basis, but in the public sector, due to the purchase of municipal bonds. And it appears that European-American is not as involved as Franklin was in the Long Island community.

When you looked at the final bids, did this aspect enter into your consideration? I certainly recognize the fact that you were at a point where it was difficult to find a bid substantial enough to participate—but nonetheless, when looking and determining which would be the successful bidder, did the community involvement of the institution come into consideration?

In other words, European-American is controlled by foreign banking interests, and perhaps they are not as concerned with the type of image that the domestic banks here tell us they like to have, in that they participate in their community. They appoint a couple of their managers as chairmen of the United Way and Red Cross appeal, and they do their share in the buying of municipal bonds. Did that enter into your considerations?

Chairman WILLE. I am pleased that the question has been asked, Mr. Chairman, because I think there is a certain amount of misinformation about that particular aspect of the transaction generally. The FDIC itself did not consider this in its activities. As receiver, we felt an obligation to accept the highest bid which was submitted. However, the State superintendent of banks in New York certainly did consider this, and his approval, as well as the approval of the

New York State Banking Board, was required befor the entire transaction could have been accomplished with court approval. He was very concerned about precisely the questions which you are raising, although I think it fair to point out that whereas Franklin was a $4 billion bank, and was making loans to the extent of $2.4 billion or so, the assets being taken over by any successful bidder here were going to be about $1.4 billion, so that you already had a significant cutback of the size of the Franklin operation which would be continued by the successful bidder.

Now, the State superintendent in New York satisfied himself not only that European-American had the management capability to take over the 103 Franklin branches on Long Island, and in New York City, but that it also had a firm desire to serve that market. In effect, European-American's representations were that as a foreign bank, they would be entering the New York retail market with certain disadvantages which they would have to overcome by strenuous effort to cultivate that market, and to do this they would have to maintain the banking relationships that they were taking over in the $1.4 billion of assets they selected.

Mr. ST GERMAIN. Can I interrupt you? In your opinion, is European-American, in this instance—primarily interested in deposits or in investments? In other words, are they looking to build up their deposits there, or do they use European-American as a vehicle for investing in the United States? I think perhaps that requires just a personal judgment that we would not hold you to.

Chairman WILLE. Well, my personal view is that the shareholders of European-American were interested in expanding their investment possibilities in the United States, and that they wanted to penetrate the New York banking market and establish a sizable and respectable entity in the New York market. I think they realize that to make their investment pay off, and this expansion of their deposit base required substantial new capital from both the parent banks as well as the FDIC, the only way it can, long term, is to serve the Long Island community at least to the extent of the size of their bank.

I believe that they have been active participants in the Long Island banking community. Mr. Ekblom, who is the chairman of the European-American and its chief executive officer, was formerly an executive officer of the Chase Manhattan Bank. He is a U.S. citizen and a very highly regarded member of the Long Island community. He, too, is very active in the community affairs to which you referred at the outset, and I believe that his example will be reflected in the conduct of subordinate officers as well, and already is.

Mr. ST GERMAIN. It appears to me that when our domestic banks establish branches in foreign lands, it is not usually for deposits but for investment opportunities.

Chairman WILLE. When a U.S. bank goes abroad?

Mr. ST GERMAIN. Yes.

Chairman WILLE. Well, it may be equally important for the U.S. bank to serve its domestic or international customers overseas. It has an awful lot of traveling Americans who may be its customers, and it may also be servicing multinational corporations which have plants and businesses overseas that they service back home——

Mr. ST GERMAIN. The responsibility of receiver-shareholders in a case where a bank holding company is involved are not too well understood, I think. It is true that there were no individual shareholders in Franklin National Bank, but instead all the stock in the bank was owned by the holding company, Franklin National Corp.?

Chairman WILLE. There actually is preferred stock in the Franklin National Bank. The preferred stock is owned by former owners, I believe, of the Federation Bank & Trust, largely in New York, which merged with the Franklin when it entered New York City.

Mr. ST GERMAIN. But not common stock?

Chairman WILLE. The common stock was held by the holding company, and there may have been directors' qualifying shares out. But I think you are right that, as far as the common stock was concerned, virtually all of it was held by the holding company.

Now, the holding company itself was publicly owned.

Mr. ST GERMAIN. Now, that being the case, did the holding company actually hold anything beyond Franklin National Bank of any consequence?

Chairman WILLE. Not of significant consequence.

Mr. ST GERMAIN. That being the case, does FDIC, as a receiver, have any responsibility to the public shareholders of Franklin National Corp.?

Chairman WILLE. Our responsibility to those shareholders is derivative of their rights through the Franklin holding company. We recognize that we have a significant responsibility to the parent holding company, as the holder of all the common stock of the Franklin National Bank, to realize the maximum we can from the assets in our hands for collection. To the extent that we are successful in realizing maximum value, those public shareholders of the holding company will share in distributions made by the trustee in bankruptcy of the parent holding company.

We have established a good working relationship with the gentleman who is the trustee in bankruptcy of the parent holding company, and he is kept apprised on a current basis of significant decisions which are made by us in the bank receivership. There is no lack of liaison and no information which is being withheld in any way from the trustee in bankruptcy of the parent holding company.

Mr. ST GERMAIN. Would the shareholders have been better off had they been shareholders in the bank, rather than shareholders in the holding company?

Chairman WILLE. That is too early to say, Mr. Chairman. The holding company, in addition to its shareholders, also has other creditors, one of whom is the Manufacturers Hanover Trust Co., to the extent of some $30 million or more. I am not sure of the exact figure right now. We will make a distribution first to the remaining creditors, senior and subordinated, of the bank, then to the preferred shareholders of the bank, and thereafter to the common stockholders of the bank, if we are successful in our liquidation efforts. That means our final distribution is to the holding company trustee. The holding company trustee is then required, I assume, to distribute the funds he receives first to the creditors of the holding company, and then subsequently to the shareholders of the holding company.

So I assume that the general creditors of the holding company will have first claim on any distribution we make on behalf of the common shareholders of the bank.

Mr. ST GERMAIN. Since Mr. Sindona is not a U.S. citizen, he was not able to be a director of the bank itself. But because of his stockholdings he was a director of the holding company, is that accurate?

Chairman WILLE. I would have to check that, sir, but I think you are correct.

Mr. ST GERMAIN. Well, that being the case, and I am quite sure I am correct, do you feel that this is one of those special circumstances or is there frequently an overlapping of policymaking between the holding company and the bank and furthermore, does this afford sufficient protection for the bank? In this case, Franklin National Corp. was actually a holding company but most everything held was Franklin National Bank. Therefore the directors of the holding company, in essence, set the policy for the bank. Is this helpful and does this afford sufficient protection for the bank?

Now, as a regulator, you can look at the competence, as you were saying earlier, the honesty and what have you of the officers and managers of the bank but can you look at the competence and honesty of the officers and principal stockholders and controlling interest in the holding company that directs the bank?

Chairman WILLE. Well, you are quite right in indicating that the introduction of the holding company organization and mechanism is a complicating factor in bank supervision and examination. However, the agency that examines the bank also has authority to examine any affiliate of the bank they are examining. And that would mean that the Comptroller could examine the affairs of the parent holding company and any subsidiary corporations of the holding company.

Mr. ST GERMAIN. The affairs, but how about the management?

Chairman WILLE. I am getting to that point.

Mr. ST GERMAIN. I am sorry.

Chairman WILLE. He may not have the same authority over a corrective program in the holding company that he might over a corrective program in the bank including its management. However, the Federal Reserve System which administers the Bank Holding Company Act recently was given cease-and-desist powers under the Federal Bank Holding Company Statute. And I am sure that in cooperation with the Comptroller's efforts to correct a situation in a given national bank which was a major subsidiary of a holding company that it would act cooperatively to bring about a complete correction of the problem by using its powers over the holding company.

But it does require joint action between the two, I think, to successfully resolve the issue.

Mr. ST GERMAIN. Realistically, has not the Federal Reserve limited itself to approving activities for holding companies, in other words acquisitions by bank holding companies more than anything else?

Chairman WILLE. I know that their interest in the bank holding company structure has not been limited to permissible activities or specific acquisitions.

Mr. ST GERMAIN. Because they are closely related to banks?

Chairman WILLE. That is right. This was the first onrush of applications which they received right after 1970. But I am confident that

certainly in the last 2 to 3 years that they have been very much involved in the safety and soundness of bank holding companies and the relationship of those holding companies with insured banks.

Mr. ST GERMAIN. You know it takes a lot expertise to keep up with the banks let alone bank holding companies and I think you yourself question this. I am always concerned as to whether or not the regulatory agencies have sufficient qualified personnel. We have got a lot of questioning to submit to you on this.

But then when you go into customs brokerage houses and other activities, that it is asking a lot of a bank examiner to be knowledgeable in these additional areas. It is complicated enough to know how to examine a bank and as you said, one of the problems we hear every now and then is the fact that you rely on your examiners' reports and their accuracy and it can happen on occasion that they are not accurate. There may be some who disagree with me, but, I feel there were some inaccurate examinations in the USNB for a period of time. I am not stating that the examiners did it purposely. It is just that they did not catch what was there to be caught or they did not find what was there to be found and which eventually was found by Examiner Martin.

So, the competency of an examiner is very important. You have some very competent ones and then you have some who are mediocre and if you ask them to become experts in these areas outside the banking field we are then perhaps asking too much of these examiners?

Chairman WILLE. We are asking a great deal of the examining forces of the three different agencies and in fact, their responsibilities seem to have become broader year by year as they are asked to undertake new responsibilities, particularly recently, in the consumer protection area.

But, getting back to your initial question about examiner forces and levels, I believe you are correct that you asked the question of Governor Holland because the Fed does have the immediate bank holding company supervision responsibility. His answer was that the Fed had increased its examiner force and I find that to be an interesting answer because during this period of time while their bank holding company responsibilities have increased the actual number of State member banks—that is the banks that they are examining—has been going down. And to recognize that the Fed has not only put the excess manpower that it might have obtained from the decline in the number of banks it is examining to work on the holding company problem, but then to have added new examiners to that and have a net increase, would indicate to me that there has been serious attention given to this problem at the Federal Reserve System and that they are developing the expertise that they need to supervise and regulate bank holding companies.

Mr. ST GERMAIN. And that is a need?

Chairman WILLE. Clearly there is a need. We ourselves at the FDIC are expanding our own total of examiners which we have held fairly constant—for about 4 or 5 years—at 1,600 examiners.

We authorized around the first of the year an increase of 75 and are now authorizing further increases at the rate of about 150 examiners per year. So, that I think for the next few years we ourselves will be adding significantly to the total number of examiners in the corporation.

Mr. ST GERMAIN. Many of the witnesses have referred to the costs involved to comply with title III of 8024, the disclosure by census tract of mortgages that have been granted in a particular census tract. Do you feel as though this cost factor is a terribly important one? Dr. Sternlieb who is an adviser at the Bureau of the Census, made the statement last week that at a dollar a mortgage he would like to go into the business because he feels he could make money.

Also Mr. Greenwood from Minneapolis who represented the National Savings & Loan League stated that they did it by ZIP code which was a relatively inexpensive way. Do you feel as though the cost is a terribly important factor?

Chairman WILLE. I must say that I do not consider it a significant factor in this equation. I think some banks may have to program for computers and obtain the information needed for recordkeeping purposes and that this will take some initial effort and initial expense. But it is not significant.

It may be more significant for the banks which are still on manual operations.

Mr. ST GERMAIN. Well, that just means they might not have as many mortgages to record.

Chairman Wille, once again, we have to express our deep appreciation and admiration to you for your assistance to the subcommittee. The statements have been very helpful, the prepared statements and your answers to our questions that run the gamut have been exceptionally helpful.

The questions were all asked in a spirit of seeking information and we hope to be able to continue to work with your staff as we proceed with the FINE study. Your staff has been very helpful to us and we hope to continue this relationship. Thank you very kindly.

Other members who could not be here for the hearing—in fact they are at the full committee meeting going on right now that was scheduled as of Friday—will no doubt have some questions to submit in writing as will the chairman and others. We will ask you to answer them for the record.

[The questions referred to may be found in appendix A.]

Mr. ST GERMAIN. The following statements are to be inserted into the hearing record, if there is no objection, that from D. Donald Jamieson, First Pennsylvania Bank, who commented on title II of 8024; James Stokes Hatch, vice president, Lenox National Bank, Lenox, Mass., on title II; Thomas R. Williams, president, First National Bank of Atlanta on the same title; William H. McKenzie, executive vice president, Birmingham Trust National Bank on the same title; Steven J. Kohn, vice president, Economics Union Commerce Corp., Cleveland, Ohio; and the Reverend Monsignor Lawrence J. Corcoran, executive director, National Conference on Catholic Charities. The last one, Monsignor Corcoran, comments on title II.

[The statements referred to may be found in appendix B.]

Mr. ST GERMAIN. The subcommittee will keep the record open for a period of 1 week for the purpose of receiving additional statements. The Chair has been contacted by other members of the subcommittee on behalf of some of their constituents who want to submit statements.

So, we shall keep the hearing record open for receiving these statements for a week from today.

With that, I would record our very deep appreciation to the subcommittee for their assistance and participation and we would hopefully not meet until some date subsequent to September 1.

The subcommittee is adjourned.

[Whereupon, at 4:20 p.m., the subcommittee adjourned, subject to the call of the Chair.]

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